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# Supreme Court of the United States

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,
*Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## PETITION FOR WRIT OF CERTIORARI

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## QUESTION PRESENTED

There is a deep, irreconcilable and widely noted conflict among the Second, Fourth, Sixth and Federal Circuits about the meaning of 26 U.S.C. § 67(e) – which permits trusts and estates to deduct on their income tax returns certain administrative expenses – and whether the statute permits fees for investment management and advisory services to be fully deducted on trust's and estate's income tax returns. This is an important and recurring question of federal tax law that involves deductions by trusts and estates that total in the billions of dollars annually.

The Question Presented is:

Whether 26 U.S.C. § 67(e) permits a full deduction for costs and fees for investment management and advisory services provided to trusts and estates.

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## PETITION FOR WRIT OF CERTIORARI

Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit (Petition Appendix ("App.") 1a-19a) is published at 467 F.3d 149. The decision of the Tax Court (App. 20a-30a) is published at 124 T.C. 304.

## JURISDICTION

The judgment of the Court of Appeals was entered on October 18, 2006. App. 1a. A timely Petition for Rehearing was denied on January 19, 2007. App. 31-32a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

## RELEVANT STATUTORY PROVISION

Section 67(e) of the Internal Revenue Code, 26 U.S.C. § 67(e), provides in relevant part:

> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that--
>
> > (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate. . .
>
> shall be treated as allowable in arriving at adjusted gross income.

## INTRODUCTION

This case raises an important and recurring question of federal tax law that involves billions of dollars in annual deductible expenses and on which the courts of appeals are deeply and irreconcilably divided. The question is whether

fees for investment management and advisory services, sometimes called "investment advice" fees, may be deducted in full by trusts and estates when determining their taxable income. The dispute among the Circuits about this question has been called "perhaps the most vexing controversy currently outstanding" in the world of fiduciary income taxation,[1] and it has been widely noted, not only by courts, but in the literature as well.[2]

To give a sense of the importance of the tax treatment of the income and expenses of trusts and estates, trusts and estates reported over $85 billion of gross income in the most recent year for which statistics are available, filing almost four million income tax returns that year.[3] It can be estimated that over $1 trillion in assets are held in trusts and estates in the United States.[4] Many trustees utilize the services of professionals to provide investment management and advisory services. Internal Revenue Service (IRS) statistics

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[1] Janes, *Fiduciary Administrative Expenses: How Much Is Deductible?*, 32 Est. Plan. 21, 21 (2005).

[2] See, *e.g.*, Bell and King, *Sweeping Up the Two Percent Floor:* Scott v. United States *and the Deductibility of Investment Advisory Fees*, 38 Real Prop. Prob. & Tr. J. 589, 596 (2003) (describing the "classic split among the circuits").

[3] See Internal Revenue Service, *Statistics of Income Tax Stats – Income from Trusts and Estates* ("*IRS Tax Stats*"), at Table 3 (IRS 2005) (Fiduciary Income Tax Returns, Income, Deductions, and Tax Liability, by Tax Status, and Size of Gross Income, Filing Year 2004) available at http://www.irs.gov/pub/irs-soi/04fd03ts.xls.

[4] Over $1.1 trillion is held in personal trust and agency accounts alone in banks and trust companies in the United States. See FDIC, 2005 FDIC Trust Report and Table 1 (2006), available at http://www.fdic.gov/bank/individual/trust/report2005.html and http://www.fdic.gov/bank/individual/trust/table1.htm. In a recent year, decedents' gross estates valued individually at over $625,000 held in total $195.6 billion (measured at the time of the decedents' deaths). See Johnson and Mikow, *Federal Estate Tax Returns, 1998-2000* at 135 (IRS 2001), available at http://www.irs.gov/pub/irs-soi/00esart.pdf.

indicate that each year trusts and estates incur costs of several billion dollars in fees for such services.[5]

When an individual incurs such expenses, they are not fully deductible in calculating the individual's taxable income. Congress, however, has sought to provide preferential treatment for the expenses of administration and management of trusts and estates. 26 U.S.C. § 67(e) provides that:

> the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that . . . the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income.

26 U.S.C. § 67(e).

This beneficial rule for trusts and estates has two components. Its first prong requires that for an expense to be fully deductible it must have been "paid or incurred in connection with the administration of the estate or trust." Its second prong specifies that in order for that expense to be fully de-

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[5] See *IRS Tax Stats* at Table 3. The IRS does not publish data that precisely disaggregate these costs. For the most recently reported year, IRS data show a total of $5.6 billion in deductions on fiduciary income tax returns for a category known as "other deductions not subject to the two-percent floor." Id. Until the decision below was rendered, the largest component of that category was likely deductions for fees for investment advisory and management services. The data also show a total of $1.2 billion for what are called "allowable miscellaneous deductions." Under rulings of the Fourth and Federal Circuits described in more detail below, some trusts and estates categorized their fees for investment advice in that category, and, again, such fees were likely the largest single type of deduction within that category. Finally, the data show $3.9 billion deducted in that one year for trustees' and other fiduciaries' fees. Id. These fees, too, are primarily for investment advice and management. To the extent it is relevant to this case, these categories will be described more fully below.

ductible, it must also be one "which would not have been incurred if the property were not held in such trust or estate."

The Circuits are split 1-2-1 about the meaning of this second prong, and whether it permits fees for investment management and advisory services to be deducted in full by trusts and estates. "Because of the fiduciary obligations imposed on personal representatives and trustees, these conflicting decisions [of the courts of appeals] affect every trust and every estate that files an income tax return." Balter, *Second Circuit Holds Trust's Investment Advisory Fees ARE Subject to 2% Floor*, 32 Tax Mgmt. Est., Gifts & Tr. J. 136, 136 ( 2007).

The United States Court of Appeals for the Sixth Circuit has ruled that costs that "would not have been incurred if the property were not held in such trust or estate" include those costs that are imposed upon the trustee by his fiduciary duties. *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993). Consequently, it has held that investment management and advisory fees are fully deductible under § 67(e). Id. at 304-305. The United States Courts of Appeals for the Fourth and Federal Circuits have held that that statutory language covers only those costs that are not "of a type . . . commonly" or "customarily" incurred outside trusts. See *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (CAFed 2001); *Scott v. United States*, 328 F.3d 132, 139-40 (CA4 2003). Those Courts have held that under their test, such fees are not fully deductible under § 67(e).

Finally, in the decision below, the Second Circuit has advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner." App. 13a. Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits, id. 12a, the Second Circuit held that fees paid by trusts and estates for management and investment of assets are never fully deductible. Id. 19a.

This split in authority is untenable. It relates to an important and recurring problem and while it endures, the requirements upon federal taxpayers under the Internal Revenue Code vary from Circuit to Circuit. The decision below may cause the migration of trusts to, or the appointment of trustees located in, the Sixth Circuit or the Circuits where no decision on this question has been rendered in the hope that the Sixth Circuit rule will be followed in those Circuits. As this Court has long recognized, there are few areas of law in which the need for uniformity is as clear.

The financial impact of the decision below is also enormous, both in terms of the cost to the beneficiaries of trusts and estates, and to the financial services industry that provides these investment advice and management services.

Finally, this case presents an appropriate vehicle for the resolution of the split. The question presented was dispositive below and is cleanly and squarely presented. The issue has more than sufficiently percolated in the lower courts. Indeed, the Second Circuit's decision to coin a new test rather than adopting either the Sixth Circuit's approach or the interpretation of the Fourth and Federal Circuits indicates that further percolation may produce only greater conflict and confusion. Certiorari therefore should be granted.

## STATEMENT

1. The William L. Rudkin Testamentary Trust ("Trust" or "Rudkin Trust") was established in 1967 under the will of Henry A. Rudkin, Sr. ("Rudkin" or "Henry Rudkin"). Rudkin, with his wife Margaret, founded Pepperidge Farm, maker of cookies and other food products. The Trust was funded with proceeds of the 1961 sale of Pepperidge Farm to the Campbell Soup Company. The Will and its First Codicil (the "Trust Documents") state that the Trust income and principal may be distributed by the Trustees of the Trust at their discretion for the "support, comfort, and education" of any or all members of the class comprising Rudkin's son William L. Rudkin, his wife or widow, and his descendants

and their spouses. App. 35a, 45a-46a. In addition, the Trust Documents specify that the principal may be distributed by the Trustees at their discretion "to advance the best interests of such member or members [of that class] in any business venture in which such member or members may be engaged or in which such members may wish to engage." App. 45a-46a.[6] At the beginning of the tax year at issue in this case, 2000, the Trust had assets worth $2,884,542.00.

The Trust is designed to last for generations. It expires twenty-one years after the death of the last survivor of Henry Rudkin's descendants living at the time of his death (or, if it occurs earlier, upon the deaths of William L. Rudkin and all of his descendants). App. 36a. The youngest of Rudkin's descendants who were living at the time of his death, Katharine Rudkin Allsopp, is now 46 years old. If she lives to be eighty, the Trust will not expire until 2063.[7]

The Trustees must comply with certain obligations in their management of the Trust assets:

•To begin with, the Connecticut Probate Court has appointed a guardian *ad litem* to protect the interests of the unborn beneficiaries of the Trust. See *Estate of Henry A. Rudkin*, Order of the Probate Court for the District of Fairfield, Fairfield Probate Court Records, Vol. 288, p. 644 (December 21, 1970). The Trustees are required to file a detailed principal and income trust accounting with the guardian and the Probate Court every three years. See Conn. Gen. Stat. § 45a-177.

•The Trust Documents do not provide any safe harbor for the Trustees in their decisions about investing the Trust assets. Rather the Trust Documents provide that the Trustees

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[6] The Trustees are also required to distribute portions of the trust principal to any persons or organizations designated by William L. Rudkin during his life or in his will if it was duly admitted to probate (except for William L. Rudkin himself or his estate or their creditors). App. 36a.

[7] Upon the Trust's expiration, its assets will be distributed to the living descendants of William L. Rudkin, *per stirpes*. App. 36a.

may "invest and reinvest the funds . . . in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds." App. 38a.

•Further, the Trustees are subject to the Connecticut Uniform Prudent Investor Act. Conn. Gen. Stat. §§ 45a-541a to 45a-541*l*.[8] The Connecticut statute provides that "[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust." Id. § 45a-541b(a).[9] It further specifies that "[a] trustee's investment and management decisions respecting individual assets shall be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Id. § 45a-541b(b). The statute mandates the consideration by the Trustees in investing and managing of Trust assets of ten enumerated circumstances, including "the nature and estimated duration of the trust." Id. § 45a-541b(c).[10]

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[8] Since the completion of the Uniform Prudent Investor Act in 1994, versions of the uniform law have been adopted by 44 States and the District of Columbia as the standard for trust investment law. See Uniform Law Commission, A Few Facts About the Uniform Prudent Investor Act, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp (last visited Mar. 23, 2007) (listing States).

[9] Of course, the common-law requirement of prudence in performance of a trustee's fiduciary obligations long antedates adoption of this statute. See *Harvard College v. Amory*, 9 Pick. 446, 461 (Mass. 1830).

[10] Conn. Gen. Stat. §§45a-541b(c) provides in full:

> Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) General economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions, strategies and distributions; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enter-

**2.** In order to comply with these obligations, the Trustees engaged Warfield Associates, Inc., ("Warfield"), an SEC registered investment advisor in New York, to manage the Trust assets.[11] Warfield charged the Trust an annual fee of 0.8% of Trust assets, billed quarterly. During 2000, Warfield charged, and the Trustees paid, quarterly fees totaling $22,241.31 for Warfield's services.

Trusts and estates, like individuals, must pay a tax upon their "taxable income." See 26 U.S.C. § 1. Trusts and estates must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, called a fiduciary income tax return, whereas individuals must file the more well-known Form 1040.

On the Trust's Form 1041, the Trustees included a deduction for this full amount of Warfield's fees in calculating the Trust's taxable income. Taxable income for both individuals and trusts is derived, first, by taking "gross income," defined as "all income from whatever source derived," 26 U.S.C. § 61(a), and deducting in full certain expenses that are enumerated by statute (called "above-the-line" deductions) in order to arrive at a figure for "adjusted gross income." See 26 U.S.C. § 62(a). Taxable income is calculated by subtracting from "adjusted gross income" other deductions that are also enumerated by statute (these are called

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prises, tangible and intangible personal property and real property; (5) the expected total return from income and the appreciation of capital; (6) related trusts and other income and resources of the beneficiaries; (7) needs for liquidity, for regularity of income and for preservation or appreciation of capital; (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries; (9) the size of the portfolio; and (10) the nature and estimated duration of the trust.

[11] The Trust Documents provide that the Trustees may "employ such agents, experts and counsel as they may deem advisable in connection with the administration and management" of the Trust. App. 41a. This delegation is expressly permitted by the Connecticut statute, see Conn. Gen. Stat. § 45a-541i(a).

"itemized" or "below-the-line" deductions). See 26 U.S.C. § 67(b) and Code sections cited therein. A subset of these itemized deductions, called "miscellaneous itemized deductions," however, has since the adoption of the Tax Reform Act of 1986 ("the 1986 Act") been deductible only to the extent that their aggregate "exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a). These miscellaneous itemized deductions are, in other words, no longer fully deductible; in common parlance, the 1986 Act imposed a "two percent floor" on their deductibility.[12]

Individuals may not ordinarily deduct investment management and advisory fees in full from their gross income in order to calculate their adjusted gross income. Rather, under Treasury Regulations such fees are treated as "miscellaneous itemized deductions" that are subject to the two-percent floor. See Temp. Treas. Regs. § 1.67-1T(a)(1)(ii), 53 Fed. Reg. 9870, 9875 (Mar. 28, 1988); 26 CFR § 1.212-1(g); see also 26 U.S.C. § 212.

The Tax Code, however, has long given preferential treatment to the expenses incurred by trustees for the administration and management of trusts and estates, and in the same Section of the Code where it imposed the two-percent floor, Congress also provided in the 1986 Act that:

> the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that . . . the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which

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[12] Congress limited the deductibility of these miscellaneous itemized deductions to relieve individual taxpayers and the IRS of the complexity and recordkeeping burdens that resulted when these deductions were allowed in full, and to prevent individuals from erroneously deducting expenses with "the characteristics of voluntary personal expenses" that lacked "sufficient business or investment purpose," for example, erroneous deductions for home office expenses, magazine subscriptions and safe deposit services. See H. Rep. No. 99-426 at 109-110 & n.8; S. Rep. No. 99-313 at 78-79 & n.18.

> would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income.

26 U.S.C. § 67(e).[13] The Trustees deducted the fees paid to Warfield in full because they "would not have been incurred if the property were not held" in the Rudkin Trust.[14]

**3.** Respondent Commissioner disallowed this full deduction, permitting the Trust to deduct these fees only to the extent that they exceeded two percent of the Trust's adjusted gross income. He issued a Notice of Deficiency to the Trust in the amount of $4,448.[15]

Petitioner Trustee Michael J. Knight petitioned the Tax Court for a redetermination of deficiency. See 26 U.S.C. §§ 6212, 6213, 6214 and 7442. The Tax Court sustained the Commissioner's position. The court recognized that there is "a split in authority" among the courts of appeals on the issue of the deductibility of the costs of investment advice under § 67(e). It chose to follow its own previous decision in *O'Neill v. Commissioner*, 98 T.C. 227 (1992), even though that decision was reversed by the Sixth Circuit. See *O'Neill v. Commissioner*, 994 F.2d 302 (CA6 1993), rev'g 98 T.C.

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[13] The parties agree that fees paid for investment management and advisory services are "costs which are paid or incurred in connection with the administration of the estate or trust" within the meaning of the statute. See App. 6a; *Ungermann Trust v. Commissioner*, 89 T.C. 1131 (1983) (a very broad range of costs are included within the universe of administrative costs covered by this statutory language).

[14] The Trust listed these fees on a line on Form 1041, entitled "Other deductions not subject to the 2% floor." The Trust listed no miscellaneous itemized deductions subject to the 2% floor on the Form 1041 line for such items.

[15] The parties subsequently discovered an error in the calculation of adjusted gross income in the Trust's return, and they agree the correct number is $613,263, rather than the $624,816 listed on the return. The amount of the deficiency, though, was ultimately not altered by this correction. See App. 3a.

227 (1992).[16] As the Tax Court described, in *O'Neill* it held that

> the thrust of the language of section 67(e) is that only those costs which are unique to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth at section 67(a). . . . Individual investors routinely incur costs for investment advice as an integral part of their investment activities. Consequently, it cannot be argued that such costs are somehow unique to the administration of an estate or trust . . . .

App. 26a-27a (quoting *O'Neill*, 98 T.C. at 230-231).

The Tax Court recognized that it had been reversed in *O'Neill* by the Sixth Circuit, which found that investment advice fees were fully deductible under § 67(e), see id. 27a, but noted that the decisions of the Federal Circuit in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (CAFed 2001), and the Fourth Circuit in *Scott v. United States*, 328 F.3d 132 (CA4 2003), "diverged from the position taken by the Court of Appeals for the Sixth Circuit." Id. "Having reviewed our initial construction of section 67(e)," the Tax Court concluded, "and the ensuing judicial developments detailed above, this Court concludes that the interpretation set forth in [the Tax Court decision in *O'Neill*] and expressed by the Courts of Appeals in [*Scott*] and [*Mellon Bank*] remains sound." App. 29a.

**4.** Petitioner appealed to the Second Circuit. Before that court, the Commissioner conceded that "There is currently a split in the circuits regarding whether fees paid by trusts to

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[16] The Tax Court deems itself bound to follow the decisions of a Circuit Court of Appeals only when an appeal in the case before it lies to the same court of appeals. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970). In cases in which the taxpayer is not a corporation, appeals from the Tax Court are taken to the Circuit in which the taxpayer legally resides. 26 U.S.C. § 7482(b)(1).

outside investment advisors are subject to the 2% floor." Brief for Appellee ("Gov't. CA2 Br.") at 3, *William L. Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (CA2 2006). The Commissioner argued that the court of appeals should reject the Sixth Circuit decision in *O'Neill*, and follow the decisions of the Fourth Circuit in *Scott* and the Federal Circuit in *Mellon Bank*. Id. 3-4, 22-24.

A two-judge panel of the Second Circuit affirmed, but on reasoning that differed from that of the Tax Court.[17] In an opinion written by Judge Sotomayor and joined by Judge Hall, the Second Circuit declined to follow either the Sixth Circuit or the Fourth and Federal Circuits.

The court began by canvassing "[t]he Circuit Split" on the question before it. App. 7a-9a. It determined that the Sixth Circuit had held that § 67(e) permitted a full deduction for costs caused by a trustee's fiduciary obligations, App. 7a (citing *O'Neill*, 994 F.2d at 304), and that the Fourth and Federal Circuits had held that only costs "customarily" or "commonly" incurred by individuals were fully deductible. Id. 7a-9a (citing *Mellon Bank*, 265 F.3d at 1280-81 and *Scott*, 328 F.3d at 139-40).

The Second Circuit then rejected each of the interpretations put forward by its sister Circuits. Despite the statutory phrase describing costs "which would not have been incurred if the property were not held in such trust or estate," the court concluded that "nothing in the statute indicates the Congress intended to make applicability of the deduction dependent on what costs are peculiarly incurred by a specific trust." App. 13a. Rather, the court concluded that the "plain meaning" of that phrase "excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust." App. 11a (emphasis in original). "We . . . hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs

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[17] Judge Feinberg, who was originally on the panel, recused himself after oral argument. See App. 2a n.*.

that could not have been incurred by an individual property owner." App. 13a.

Applying this test, the court ruled, contrary to the Sixth Circuit, that

> the fact that investment-advice fees are subject to the two-percent floor under regulations applicable to individual taxpayers proves the fees to be a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust. By contrast, costs that individuals are incapable of incurring, like 'fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns,' *Scott*, 328 F.3d at 140, are fully deductible.

App. 12a. The court also made clear that it "disagree[d]" with the Federal and Fourth Circuits, stating that it was adopting a "more restrictive" reading of the statute than they had. App. 12a.[18]

The court asserted that even if the meaning of the statute were not plain, "canons of statutory interpretation favor[ed]" its conclusion because "when the statute is ambiguous, we resolve interpretive disputes as to the availability of a tax deduction in favor of the government." App. 14a. Finally, the court asserted that, because it had found the language of

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[18] In reaching its conclusion about the meaning of the statute, the court expressly declined to rely upon legislative history upon which the Federal Circuit had relied, noting that it "predate[d] the introduction of § 67(e)(1)'s second clause." App. 15a n.4; cf. *Mellon Bank*, 265 F.3d at 1281. It also "did not adopt the Federal and Fourth Circuit's view" that reading the statute to permit the deduction of investment advice fees would render that second clause superfluous because it would mean that all administrative costs were fully deductible. App.18a-19a n.7. See *infra* at 24-25 & n.24.

the statute unambiguous, it did not need to address its legislative history. But it asserted that, in any event, nothing in that legislative history "supports the Trust's proposed interpretation of the statute . . . or provides any reason to depart from our reading of the statute's meaning." App. 15a.

**5.** The court of appeals denied rehearing and rehearing en banc. App. 31a-32a. This Petition followed.

## REASONS FOR GRANTING THE PETITION

There is a deep, untenable and well-recognized division among the Circuits concerning the meaning of 26 U.S.C. § 67(e). It is a recurring question of enormous practical importance and financial consequence, and this case presents an ideal vehicle for its resolution.

### I. THERE IS AN ACKNOWLEDGED, IRRECONCILABLE, AND UNTENABLE DIVISION AMONG THE CIRCUITS ABOUT THE DEDUCTIBILITY BY TRUSTS AND ESTATES UNDER 26 U.S.C. § 67(e) OF FEES FOR INVESTMENT MANAGEMENT AND ADVISORY SERVICES.

#### A. The Circuits Are in Acknowledged and Irreconcilable Conflict Regarding the Deductibility of Expenses by Trusts and Estates Under § 67(e).

##### 1. The Sixth Circuit.

The Sixth Circuit holds that fees for investment advice and management services are fully deductible by trusts and estates since they are incurred because of the trustees' fiduciary responsibilities. In *O'Neill v. Commissioner*, 994 F. 2d 302, 304 (CA6 1993), the court addressed a trust the trustees of which, themselves having no expert knowledge in the investment of large sums of money, had hired an investment advisor to manage and invest the trust's assets. There the court held that "investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the" two-percent floor. Id. at 304. The court reasoned that because the fees had been caused by the fiduci-

ary duties of the trustees, they "would not have been incurred if the property had not been held in trust:"

> A trustee is charged with the responsibility to invest and manage trust assets as a "prudent investor" would manage his own assets. . . . Where a trustee lacks experience in investment matters, professional assistance may be warranted. The trustees here lacked experience in investing and managing large sums of money and, therefore, sought the assistance of an investment advisor. . . . [T]he investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees.

Id.[19]

**2. The Fourth and Federal Circuits.**

The Fourth Circuit and the Federal Circuit reject the Sixth Circuit's position and hold that § 67(e) does not permit the full deduction of fees for investment management and advice by trusts and estates because they are expenses "of a type . . . commonly" or "customarily" incurred outside trusts. See *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1280-1281 (CAFed 2001); *Scott v. United States*, 328 F.3d 132, 139-140 (CA4 2003).

In *Mellon Bank*, the Federal Circuit held that fees for investment advice were subject to the two percent floor under the "plain meaning" of the statute. The court reasoned that "[a]ll expenses resulting from the fiduciary obligations of the trustee" satisfy the first prong of § 67(e), *i.e.*, that they are all "costs which are paid or incurred in connection with the administration of the estate or trust." Id. at 1280. The Com-

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[19] Fiduciaries, the court went on "uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." Id. They differ in this regard, the court noted from individual investors who "are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." Id.

missioner conceded, as he did in this case, that "trustee fees are fully deductible." Id. at 1279. Appellant Mellon Bank argued that "[s]ervices delegated by the trustee remain subject to fiduciary standards and are fiduciary services under governing law," and that therefore payments for such services, too, were fully deductible. Id.

The Federal Circuit reasoned that if this were correct "all expenses incurred by a trustee in connection with the administration of a trust would be fully deductible." Id. at 1280. This, the court concluded, would read out of the statute the "second prong" of § 67(e) – the requirement that only administrative costs that "would not have been incurred if the property were not held in such trust or estate" are fully deductible. Id.

In an attempt to craft an interpretation that would "give full effect" to the statute and not render any of its language superfluous, the court asserted that the second prong of § 67(e) "focus[ed]" on "the type of costs" at issue. Id. at 1281. It concluded that "the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." Id.

> Investment advice and management fees are commonly incurred outside of trusts. An individual taxpayer, not bound by a fiduciary duty, is likely to incur these expenses when managing a large sum of money. Therefore, these costs are not exempt under section 67(e)(1) and are required to meet the two percent floor of section 67(a).

Id.

The *Mellon Bank* decision was followed by the Fourth Circuit in *Scott*. Noting that "[o]ur sister circuits have split over the proper resolution of the legal issue here," 328 F.3d at 135, the Fourth Circuit concluded "we find ourselves in agreement with the Federal Circuit's reasoning in *Mellon Bank*, and thus render a decision at odds with the Sixth Cir-

cuit's holding in *O'Neill*," the analysis in which, the court concluded, "contains a fatal flaw." Id. at 140.

The Fourth Circuit concluded that the language of the statute was "clear and unambiguous." Id. at 139. It stated that "[t]he verb 'would' in the context of § 67(e)(1) expresses concepts such as custom, habit, natural disposition, or probability." Id. at 139 (citing Webster's Third New International Dictionary 481 (1976) and American Heritage Dictionary of the English Language 2042, 2059 (3d ed. 1992)).

> Thus, "the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Mellon Bank*, 265 F.3d at 1280-81; *see also Mellon Bank, N.A. v. United States*, 47 Fed. Cl. 186, 188-89 (Fed. Cl. 2000). Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers.

Id. at 139-140.

Applying this test, the court asserted that "investment-advice fees are commonly incurred outside the context of trust administration," and held the fees not deductible. Id. at 140. The court concluded that "holding that a trust's investment-advice fees were fully deductible" would "render meaningless the second requirement of § 67(e). . . . To give effect to this limitation, we must hold that the investment-advice fees incurred by the Trust do not qualify for the exception created by § 67(e). Rather, they are subject to the 2% floor established by § 67(a)." Id.

**3. The Second Circuit.**

Finally, the Second Circuit has now rejected the positions of the Fourth, Federal and Sixth Circuits, holding that fees for investment management and advisory services are not deductible by trusts and estates under § 67(e) regardless of

how "commonly" they are incurred outside of trusts and estates, because they are costs of a type that "could be" incurred by an individual taxpayer. App. 11a.

The court below explicitly acknowledged the split among the Circuits. App. 7a-9a. It noted that the Sixth Circuit had "held that 'the investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the base of two percent of adjusted gross income.'" App. 7a (quoting *O'Neill v. Comm'r*, 994 F.2d 302, 304 (CA6 1993)). The Sixth Circuit's *O'Neill* decision, the Second Circuit said, "established the rule that a trust's costs attributable to the trustee's fiduciary duty, and not required outside the administration of trusts, fall within the § 67(e)(1) exception and are therefore fully deductible." Id.

The Federal Circuit, the court went on, "rejected this reasoning." Id. In *Mellon Bank*, the Second Circuit explained, the Federal Circuit held that the statute "'treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts,'" and concluded that "because '[i]nvestment advice and management fees are commonly incurred outside of trusts,'" they are not fully deductible when incurred by trusts, but are subject to the two-percent floor. Id. 8a (quoting *Mellon Bank*, 265 F.3d at 1281).

Finally, the court below recounted, the Fourth Circuit had held that "trust-related administrative expenses" are not fully deductible "if they constitute expenses commonly incurred by individual taxpayers," concluding "that because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the two-percent floor." Id. (quoting *Scott*, 328 F.3d at 139-40).

The Second Circuit then rejected both the rule articulated by the Sixth Circuit in *O'Neill*, and that adopted by the Fourth and Federal Circuits in *Scott* and *Mellon Bank*. After concluding that "the second prong of § 67(e)(1) does not ask

whether the costs at issue . . . are incurred as a result of a particular trustee's fiduciary duty," id. 11a, the court held "that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner," id. 13a, and that fees for investment advice therefore were not fully deductible. And it noted explicitly its disagreement not only with the Sixth Circuit, but with the Federal and Fourth Circuits as well:

> We . . . join the Federal and Fourth Circuits in holding that § 67(e)(1) does not exempt from § 67(a)'s two-percent floor investment-advice fees incurred by trusts. We disagree, however, with their statement that costs 'not *customarily* incurred outside of trusts' are the ones not subject to the floor, *Mellon Bank*, 265 F.3d at 1281 (emphasis added); *Scott*, 328 F.3d at 139-40 (citing *Mellon Bank* and stating that § 67(e)(1) subjects 'expenses *commonly* incurred by individual taxpayers' to the two-percent floor (emphasis added)), because. . . we believe § 67(e)(1) is more restrictive than that.

Id. 12a.

**B. The Conflict Among the Circuits on this Issue Is Untenable and Presents Particularly Serious Problems for the Administration of the Revenue Law.**

This split among the Circuits is untenable. This Court has long recognized the special need for uniform rules with respect to federal taxation. See, *e.g.*, *Commissioner v. Bilder*, 369 U.S. 499, 501 (1962) (Harlan, J.) (need for a uniform rule about a specific deduction in the face of division among the courts of appeals warrants grant of certiorari). Here the difficulty with the conflict is exacerbated both by the nature of the fees at issue and the scope of the jurisdiction of the various courts of appeals.

While this Circuit conflict endures, taxpayers in identical circumstances living in different Circuits will be subject to

different federal tax laws and will face different federal tax obligations. Tax Court appeals lie to the court of appeals for the Circuit in which the taxpayer, the trustee in these cases, has legal residence. See 26 U.S.C. § 7482(b)(1). Further, until the legal issue in this case is resolved, this recurring question will generate continuing disputes in Circuits that have not yet ruled on the issue. Treasury Regulations provide that there is no penalty for taking a position in one's tax return, even one that is not ultimately sustained, so long as there is "substantial authority" for that position. See 26 CFR § 1.6662-4(a), (d). Under those regulations, the Sixth Circuit's *O'Neill* case provides substantial authority for the proposition that trusts and estates may deduct in full fees for investment advice and management, notwithstanding the decisions of the Second, Fourth and Federal Circuits. Thus, despite the Commissioner's position on this issue, trustees in the Circuits that have not ruled on this issue are likely to continue to treat these fees as deductible in full, resulting in more enforcement, litigation, and uncertainty costs. See, *e.g.*, Levin, *Limitation on Deductions for Trusts: What Should a Trustee Do?* ("Levin"), 111 Tax Notes 445, 445-447 (Apr. 24, 2006) (urging that trustees in these Circuits should take this deduction in full).

There is thus also a substantial risk of funds migrating to the Sixth Circuit from the Second Circuit in light of the decision below, or of trusts seeking to add trustees not resident in the Circuits that have rendered unfavorable decisions. Indeed, the single largest holder of trust assets in New York[20] has already advised its customers in the wake of the decision below that, while investment advice fees will be subject to the two-percent floor if that bank is the sole trustee, "if there are any co-trustees who reside outside the Second, Fourth or Federal Circuits, we ask that for 2006 you do not apply the 2% limitation if there are any applicable expenses." Letter

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[20] See FDIC, 2005 FDIC Trust Report, Table 4 (2006), available at http://www.fdic.gov/bank/individual/trust/table4.htm.

of A. Dean Theiss, Jr., Vice-President & Manager Fiduciary Specialized Services, JPMorgan Private Banking, JPMorgan Chase & Co., February 21, 2007, reprinted at App. 49a-52a.

## II. THIS RECURRING ISSUE IS ONE OF FUNDAMENTAL IMPORTANCE TO TRUST BENEFICIARIES AND THE FINANCIAL SERVICES INDUSTRY.

The magnitude of this issue and its practical importance reinforce the conclusion that certiorari is warranted. As described above, fees incurred by trustees for investment advice and management can be estimated to total in the billions of dollars each year. The defining feature of a trust (or an estate), of course, is its division of title to the property into separate legal and equitable interests. The legal interest is held by the trustee, but the equitable interest is held by the beneficiaries. And while these fees are paid by the trustees, those most directly harmed are trust and estate beneficiaries of all kinds, be they an individual's surviving family members, as in this case, individuals unable to manage their own affairs, through age, disability or the like, or, in the case of estates, beneficiaries named in a will.

Subjecting these fees to the two-percent floor increases the tax liability of a trust or estate. Ultimately this reduces the size of the trust corpus – and its future earnings over time. And, if the ruling below is allowed to stand, trust assets will be reduced not just once, but annually. Cf. Janes, *Fiduciary Administrative Expenses: How Much Is Deductible?*, 32 Est. Plan. 21, 22 (2005) (noting that if these fees are subject to the two percent floor there can be "a sizable loss of deductions"). The resolution of this question therefore is of profound significance to current and potential trust settlors and beneficiaries – and, in light of the amount of tax revenue involved, to the United States.

The financial services industry, too, is seriously affected by the legal issue in this case. The split in authority that was deepened by the decision below may have serious consequences for the financial services industry in New York, as

trustees, settlors and beneficiaries seek ways to avoid the two-percent floor that may include abandonment of New York-based trustees in favor of trustees located elsewhere in the country. Financial services companies are typically chosen both to serve as trustees and to provide management and advisory services for those trusts; individual trustees in the Second Circuit also typically obtain investment management and advisory services from financial services companies in the Circuit, particularly in New York.

Even apart from the incentives created by the lack of nationwide uniformity, the decision below could have serious consequences for this sector of the economy. Under the Second Circuit's decision, trustees will have an interest in attempting to fulfill their fiduciary responsibilities of prudent investment without incurring investment management and advice fees subject to the two-percent floor. This would be bad for the financial services industry and for those for whom trust assets are held.

Some, particularly smaller trusts, may take their assets out of management and attempt to invest them in mutual funds, the costs of which are always deductible. See 26 U.S.C. § 67(c)(2). Others may try to use brokers, who typically charge nothing for their advice, but only commissions for purchases and sales, which are included in the cost basis for securities and deducted from the gain upon sale such that they are effectively excluded from taxable income, see 26 CFR § 1.263(a)-2(e). Many will also likely seek trustees who are themselves skilled in investment, so that no separate investment advice and management fee need be incurred. This is an approach that has been described repeatedly in the literature.[21] The Commissioner takes the position that under

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[21] See, *e.g.*, Satchit, *Estates, Trusts & Gifts: Trusts, Investment Advisory Fees and the 2% Floor*, Tax Adviser, Feb. 2004 at 87, 88; Hohos, *Fees Paid By Trustees For Investment Strategy Advice and Management Services are not Deductible Under Section 67(e)(1):* Mellon Bank, N.A. v. United States, 54 Tax Law. 693, 699 (2001).

§ 67(e) "[t]rustee's fees" are not subject to the two-percent floor. See Gov't. CA2 Br. at 24. Trustees, though, are paid primarily to manage trust assets, something reflected in the fact that such fiduciary fees totaled $3.9 billion in 2004, the last year for which data is available.[22] The concern of the financial services industry about the decision below can be seen in the steps already being taken by some banks to address that decision while retaining their trust clients. See App. 49a-51a.

## III. THE READING GIVEN THE STATUTE BY THE COURT BELOW IS CLEARLY IN ERROR.

### A. The Second Circuit's Interpretation of the Statutory Language is in Error; Under its Most Natural Reading, the Statute Permits the Deduction in Full of Fees for Investment Management and Advisory Services.

1. While certiorari thus should be granted regardless of what position on the merits is correct, in fact, the construction given the statute below is clearly in error, and requires reversal. Section 67(e) provides that the trust's administrative expenses are fully deductible so long as they "*would* not have been incurred if the property were not held in such trust or estate." 26 U.S.C. § 67(e) (emphasis added). The Second Circuit held that "the plain meaning of the statute permits a trust to take a full deduction only for those costs that *could*

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[22] See *IRS Tax Stats* at Table 3 (IRS 2005), available at http://www.irs.gov/pub/irs-soi/04fd03ts.xls. The Commissioner has suggested that he has "authority to require trustees to 'unbundle' their fees" presumably to determine what portion of them might be attributable to investment management and advice. See Gov't. CA2 Br. at 56. The Commissioner, however, has never issued regulations requiring disaggregation of such fees, despite his longstanding position that fees for investment advice and management are subject to the two-percent floor. The burden upon the IRS and the taxpayers of evaluating the proportion of such fees attributable to investment advice and management in each case, including the enormous difficulty that would be involved in auditing this question, is another substantial cost that would be imposed if the statute were consistently read as the Commissioner urges.

not have been incurred by an individual property owner." App. 13a (emphasis added).

This is wrong and the court's reasoning cannot withstand scrutiny. Asking whether something "would not" have been incurred is not the same as asking whether it "could not" have been incurred. Not even the Commissioner urged this construction upon the court below. See Gov't. CA2 Br. at 22-24 (urging the court to adopt the *Mellon Bank/Scott* reading of the statute). The Second Circuit's construction is plainly in error.

The best reading of the statute simply tracks its language: "[C]osts which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable." 26 U.S.C. § 67(e). The fees at issue here, for advice on how to invest Rudkin Trust assets consistent with the purposes of that trust "would not have been incurred if the property were not held in such trust." That is the end of the matter. These fees, therefore, should be fully deductible.

**2.** This reading does not render the second prong of § 67(e) superfluous. There are, indeed, administrative costs that a trustee can incur that would have been incurred even if the property were not held in the trust at issue. The primary example of these are administrative costs that are passed through to the trust from so-called pass-through entities. Pass-through entities include partnerships and S corporations. Such entities do not pay income tax themselves, but "pass through" their income, deductions and credits, which are reported by their ultimate owners. See, *e.g.*, 26 U.S.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.")

Pass-through entities can be abused because the tax law may allow them to claim on their own tax returns deductions

in full that would, if taken directly by their owners, have been subject to the two-percent floor. These deductions would be passed through to their owners on the form used by the pass-through entity to report to its owners their share of income and deductions.

The 1986 Act included a provision to restrict the ability of individuals to indirectly deduct expenses of pass-through entities in this way to avoid the two-percent floor. See 26 U.S.C. § 67(c).[23] The second prong of § 67(e) effects a parallel restriction on trusts and estates. If a trust were a partner or shareholder in a pass-through entity, that entity could incur expenses in its administration, and pass them through to the trust, reporting them as deductions on the tax form sent to the trust. The trust could then record them as administrative expenses on its tax return. But in most circumstances these expenses "would . . . have been incurred" regardless of whether the interest in the pass-through entity was or was not "held in such trust or estate." When an individual owns an interest in a pass-through entity, these costs are subject to the two-percent floor. The second prong of § 67(e) makes clear that when a trust owns an interest in a pass-through entity, these costs may also be subject to the two-percent floor. Indeed, the legislative history of that second prong confirms that this was its primary purpose. See H.R. Conf. Rep. No. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.[24]

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[23] 26 U.S.C. § 67(c) provides in relevant part: "The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection."

[24] In both the original House and Senate versions of the bill, § 67(e) did not contain a second prong. In both versions, it read simply "For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that deductions for costs paid or incurred in connection with the admini-

**B. There is No Basis for Reading the Statute as the Fourth and Federal Circuits Have.**

In the absence of a superfluity problem, there is no basis for adopting the *Mellon Bank* court's reading of § 67(e) as asking about different "types" of expenses. The statute does not ask if expenses are like those that are incurred by individuals. It asks about the specific expenses incurred by the particular trust that is claiming the deduction: Are they "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate"?

And, while the *Scott* court is correct that the word "would" is sometimes used "to expres[s] concepts such as custom, habit, natural disposition or probability," 328 F.3d at

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stration of the estate or trust shall be treated as allowable in arriving at adjusted gross income." See H.R. 3838 (99th Cong., 1st Sess, Dec. 17, 1985) (House version); H.R. 3838 (99th Cong. 2d Sess., May 29, 1986) (Senate version). The second prong was added in the Conference Committee. Its legislative history, therefore, lies solely in the Conference Report, which makes clear that Congress had in mind preventing estates and trusts from indirectly deducting administrative costs of pass-through entities:

> Pursuant to Treasury regulations, the floor is to apply with respect to indirect deductions through pass-through entities . . . In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid and incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are not subject to the floor. The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.

H.R. Conf. Rep. No. 99-841, pt. 2, p. 34 (1986), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.

139, that is obviously not the sense in which it is used here. See, *e.g.*, Merriam-Webster Collegiate Dictionary 1445 (11th ed. 2003) (giving as an example of the use of the word "would" to "express custom or habitual action" the phrase "we would meet often for lunch"); Webster's New International Dictionary of the English Language 2955 (2d ed. 1956) (describing the use of "would" to describe custom or habit as a "special use"). The statute is not asking about what happened in the past customarily or habitually. It is asking concretely with respect to "the" particular trust or estate whether the administrative expense at issue is one "which would not have been incurred if the property were not held in such trust or estate."

Further, determining what expenses are "customarily" or "commonly" incurred by individuals opens up a judicially unmanageable inquiry that Congress could not have intended. Are management fees "commonly incurred" by individuals? Common experience suggests that they are not. To begin with, even moderately wealthy individuals rarely hire investment management professionals to manage their portfolios. Providers of such services ordinarily won't even accept clients with assets below some high threshold. And most individuals invest primarily in mutual funds or in individual stocks that they pick themselves or that are recommended by their broker, paying only commissions and not advisory fees. Petitioner argued below that, even if the court adopted the customary-individual-cost test articulated in *Scott* and *Mellon Bank*, fees for investment management and advice do not meet it. The Second Circuit did not reach this alternative argument for reversal after it rejected the position taken by the Fourth and Federal Circuits.

More broadly, if determining whether a cost "would not have been incurred if the property were not held in such trust or estate" requires examining what an individual with such property would "commonly" or "customarily" have done, the answer will differ from case to case depending, among other things, on the amount and type of the property held in trust.

Nor is it at all clear upon what evidence a court could hope to rely in answering the question what costs individuals "customarily" incur in the myriad variable fact patterns that will be presented by different trusts.

Nor does the Commissioner even apply this "common" or "customary" costs approach consistently. The Commissioner concedes, for example, that costs for "the preparation of fiduciary income tax returns" are fully deductible under § 67(e). See Gov't. CA2 Br. at 24. The courts of appeals that have sustained his position about investment management and advisory fees have all agreed with this reading of the statute. See, *e.g.*, App. 12a; *Scott*, 328 F.3d at 140. Yet tax return preparation fees are costs of a "type" commonly incurred by individual taxpayers in the millions every tax season. "Income tax return preparation fees . . . are not unique to trusts or estates." Levin, 111 Tax Notes at 453. Regardless of who owned the property held in a trust, a tax return reporting income it has generated would have to be prepared and filed.

The Commissioner concedes, too, that "[t]rustee's fees" are fully deductible, see *supra* at 22-23, a conclusion with which the courts of appeals that have sustained his position have also agreed. *E.g.*, App. 12a. But again, trustees are paid primarily to manage trust assets. In this case, where the Trustees lacked the expertise to make investment decisions for the Trust, they delegated those functions to Warfield – and did not take any deduction for trustee fees.

Under the Commissioner's reading, where a trustee makes the investment decisions himself, the trust may deduct the fees that trustee has charged for managing the trust assets; but where those decisions are delegated, the fees charged for managing the trust assets may not be deducted. Congress surely cannot have intended such a result.

## IV. THIS CASE PRESENTS AN APPROPRIATE VEHICLE FOR RESOLUTION OF THIS SPLIT.

Finally, this case presents an appropriate vehicle for addressing the question that divides the Circuits. This Court routinely grants certiorari to resolve conflicts among the Circuits concerning federal tax law in cases in precisely this procedural posture, where a court of appeals has affirmed a Tax Court position to which it adhered after another court of appeals has reversed it on the same question. See, *e.g.*, *Commissioner v. Estate of Hubert*, 520 U.S. 93, 99 (1997); *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 206-207 (1990). In this case, the Second Circuit's erroneous reading of § 67(e) was dispositive. This case thus cleanly presents the legal issue in dispute and this case therefore presents an appropriate vehicle for resolution of the Question Presented. (Indeed, because the court below did not reach Petitioner's alternative argument below that the test of *Scott* and *Mellon Bank* was not met here, even if this Court were to disagree with Petitioner's proffered interpretation of the statute and agree with that put forward in those cases, reversal of the judgment below would be required.) There is certainly no need for further percolation of this issue. Indeed, the Second Circuit's decision to utilize its own test rather than adopting that of the Sixth or that of the Fourth and Federal Circuits indicates that additional court of appeals decisions on this question may produce only greater conflict and confusion.

Clarifying this issue now will also be particularly useful in assisting those subject to, and those who must enforce, this federal tax law. Although the aggregate amounts at stake are enormous and both the bench and bar require the guidance of this Court, because of the high cost of litigation, individual taxpayers denied this full deduction will ordinarily have insufficient incentive to pursue appeals. In this case, for example, the tax deficiency alleged for the one year at issue is only $4,448.00. Thus, while the issue clearly is a recurring one, deciding this issue now rather than later will

be of enormous benefit to innumerable taxpayers who would otherwise face this question without its resolution, as well as to the federal government.

Lastly, because New York is home to such a significant part of the financial services industry and, indeed, to such a significant portion of this nation's wealth, the decision by the Second Circuit that trusts and estates may not fully deduct investment advisory and management fees will have a more serious impact than would such a decision by any other court of appeals. This renders the need for review of the Question Presented in this case even more urgent.

## CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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MARCH 23, 2007

# APPENDIX

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# APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT.

August Term, 2005

(Argued: May 10, 2006 Decided: October 18, 2006)

Docket No. 05-5151-ag

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WILLIAM L. RUDKIN TESTAMENTARY TRUST, U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,

*Petitioner-Appellant,*

– v. –

COMMISSIONER of INTERNAL REVENUE,

*Respondent-Appellee.*

---

CAROL. A. CANTRELL, Briggs & Veselka Co., Bellaire, TX, for *Petitioner-Appellant.*

GILBERT S. ROTHENBERG, Attorney, Tax Division, United States Dept. of Justice (Eileen J. O'Connor, Assistant Attorney General; Anthony T. Sheehan, Attorney, Tax Division, United States Dept. of Justice, *on the brief*), Washington, D.C., for

*Respondent-Appellee.*

Gregory F. Taylor, Lisa Bleier, American Bankers Association, Washington, D.C., for *Amici Curiae American Bankers Association* and *New York Bankers Association.*

Before: SOTOMAYOR and HALL, *Circuit Judges.*[*]

SOTOMAYOR, *Circuit Judge*:

The question presented on this appeal is whether investment-advice fees incurred by a trust are fully deductible in calculating adjusted gross income for purposes of the Internal Revenue Code ("IRC") under 26 U.S.C. § 67(e)(1) (2000), or whether these fees are deductible only to the extent that they exceed two percent of the trust's adjusted gross income under § 67(a). Petitioner-appellant Michael J. Knight, trustee of the William L. Rudkin Testamentary Trust ("the Trust"), appeals from a decision of the United States Tax Court (Robert A. Wherry, Jr., J.). We affirm the decision of the tax court and hold that a trust's investment-advice fees are subject to the two-percent floor of § 67(a) and therefore not fully deductible in arriving at adjusted gross income.

## BACKGROUND

The parties in this case stipulated to the following facts. Henry A. Rudkin established the William L. Rudkin

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[*] Judge Wilfred Feinberg, originally a member of the panel, recused himself subsequent to oral argument. Because the remaining members of the Panel are in agreement, we decide this case in accordance with § 0.14(b) of the rules of this Court.

Testamentary Trust in Connecticut on April 14, 1967, for the benefit of his son William, William's wife and William's descendants and their spouses. The Trust was originally funded with proceeds from the sale of Pepperidge Farm, a food products company, to Campbell Soup Company. In 2000, Michael J. Knight, the trustee, engaged Warfield Associates, Inc. ("Warfield") to provide investment-management advice to the Trust. In its 2000 tax return, the Trust reported total income of $624,816 and claimed a deduction in the amount of $22,241 for investment-management fees paid to Warfield. The Trust claimed this deduction on line 15a of its tax return for "deductions not subject to the 2% floor"; the Trust claimed no deduction on line 15b for "[a]llowable miscellaneous itemized deductions subject to the 2% floor."

On December 5, 2003, the Internal Revenue Service (the "IRS") sent the Trust a notice of deficiency for the year 2000. In the notice, the IRS indicated that it rejected the Trust's itemized deduction for investment-advice fees in the amount of $22,241, and permitted such a deduction only in the amount of $9,780 (that portion of the fees which exceeded two percent of adjusted gross income of $623,050); as a result, the Trust owed $4,448 in taxes. The parties subsequently became aware that the notice contained an error in its calculation of the Trust's adjusted gross income and stipulated that the correct amount was $613,263. The parties therefore agreed that the corresponding deduction for investment-advice fees would be $9,976, but, for reasons not relevant here, agreed further that the resulting deficiency calculated in the December 5 notice would remain unchanged.

The Trust thereafter filed a petition disputing the assessed deficiency. It argued that the trustee's fiduciary duty – specifically, the investment duties defined under the Connecticut Uniform Prudent Investor Act, Conn. Gen. Stat. §§ 45a-541-45a-5411 (2005) – required investment advisory

services for the proper administration of the Trust's sizable stock portfolio and that the investment-advice fees were therefore fully deductible under § 67(e)(1). Following a trial in the United States Tax Court in Hartford, Connecticut, the tax court held that the "investment advisory fees paid by the trust are not fully deductible under the exception provided in section 67(e)(1) and are deductible only to the extent that they exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a)." *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304, 311 (2005). This timely appeal followed.

## DISCUSSION

This appeal, which we have jurisdiction to consider under 26 U.S.C. § 7482(a)(1) (2000), presents a question of statutory interpretation. In interpreting a statute, "[w]e start, as always, with the language of the statute." *Williams v. Taylor*, 529 U.S. 420, 431 (2000). "We give the words of a statute their ordinary, contemporary, common meaning, absent an indication Congress intended them to bear some different import." *Id.* (internal quotation marks omitted). "Our inquiry must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent." *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340 (1997) (internal quotation marks omitted). "The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole." *Id.* at 341, 117 S.Ct. 843. "[A]lthough a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there is no need to do so" if the statutory language is clear. *Toibb v. Radloff*, 501 U.S. 157, 162 (1991).

In considering the question of statutory interpretation presented on this appeal, we review the legal conclusions of the tax court *de novo*. *Reimels v. Comm'r*, 436 F.3d 344, 346

(2d Cir. 2006); 26 U.S.C. § 7482(a)(1) (providing that the courts of appeals "shall have exclusive jurisdiction to review the decisions of the Tax Court ... in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury"). "In particular, '[w]e owe no deference to the Tax Court's statutory interpretations, its relationship to us being that of a district court to a court of appeals, not that of an administrative agency to a court of appeals.' " *Callaway v. Comm'r*, 231 F.3d 106, 115 (2d Cir. 2000) (quoting *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (Posner, C.J.)).

I. *Statutory Framework*

Under the IRC, "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual," subject to one exception relevant to this appeal. 26 U.S.C. § 67(e). The exception provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" shall be fully deductible from gross income in calculating adjusted gross income. *Id.* § 67(e)(1). In order to understand this provision's operation, it is necessary first to comprehend the manner in which adjusted gross income is calculated for individuals.

Section 1 of the IRC imposes a tax on all "taxable income" of individuals and trusts. 26 U.S.C. § 1. In calculating taxable income, a taxpayer must first determine the amount of "gross income," which is defined as "all income from whatever source derived." *Id.* § 61(a). The taxpayer then arrives at "adjusted gross income" by subtracting from gross income certain "above-the-line" deductions, such as trade and business expenses and losses from the sale of property. *Id.* § 62(a). Finally, "taxable income" is calculated by subtracting from adjusted gross income any "itemized" (or "below-the-line") deductions. *Id.*

§ 63. In the case of an individual, "below-the-line" deductions include, *inter alia*, "all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income." *Id.* § 212.

Again in the case of an individual, "the miscellaneous itemized deductions [i.e., "below-the-line" deductions] for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." *Id.* § 67(a). Stated differently, the rule creates a "two-percent floor" for an individual's itemized deductions of the sort at issue here. Section 67(b) exempts from the two-percent floor certain specifically enumerated itemized deductions. *Id.* § 67(b). Investment-advice fees are generally treated as itemized deductions under § 212. 26 C.F.R. § 1.212-1(g) (specifying the circumstances in which "[f]ees for services of investment counsel . . . are deductible under section 212"). They are not listed in § 67(b), so are therefore not exempt from the two-percent floor established by § 67(a). Temp. Treas. Reg. § 1.67-1T(a)(1)(ii) (1988) (stating that "investment advisory fees" are subject to the two-percent floor of § 67(a)).

As noted, under § 67(e), trusts are generally subject to the same rules for calculating adjusted gross income that apply to individuals, with one exception that is relevant to this appeal. A trust's costs are fully deductible, rather than subject to the two-percent floor, if they satisfy both of the following two requirements: (1) they are "paid or incurred in connection with the administration of the . . . trust"; and (2) they "would not have been incurred if the property were not held in such trust." 26 U.S.C. § 67(e)(1). There is no dispute here that the investment-advice fees at issue meet the requirement of the first clause, that is, that the fees Knight paid to Warfield were incurred in connection with the administration of the Trust. Instead, the issue presented here, on which some of our sister circuits have disagreed, is whether the investment-

advice fees also satisfy the requirement of the second clause of § 67(e)(1) and therefore are fully deductible without regard to the two-percent floor of § 67(a).

II. *The Circuit Split*

The Sixth Circuit was the first federal court of appeals to consider the question presented here. It held that "the investment advisor fees paid by the Trust were costs incurred because the property was held in trust, thereby making them eligible for the § 67(e) exception and not subject to the base of two percent of adjusted gross income." *O'Neill v. Comm'r*, 994 F.2d 302, 304 (6th Cir. 1993). The Sixth Circuit reasoned that because a trustee has a fiduciary duty to manage trust assets as a "prudent investor," investment-advisory fees are "necessary to" the trust's administration and "caused by" the fiduciary duty of the trustee. *Id.* The court reasoned further that although individual investors often incur costs for investment advice, "they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves." *Id.* In short, O'Neill established the rule that a trust's costs attributable to the trustee's fiduciary duty, and not required outside the administration of trusts, fall within the § 67(e)(1) exception and are therefore fully deductible.[1]

The Federal Circuit rejected this reasoning in *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001). In *Mellon Bank*, the court held that the second clause of § 67(e)(1) "serves as a filter" with respect to the first clause

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[1] The American Bankers Association and the New York Bankers Association, appearing in this case as *amici curiae*, advocate the position adopted by the Sixth Circuit. They contend that investment-advice fees incurred by a trustee are fully deductible under the statute "because the prudent execution of the duties imposed upon a trustee rendered it necessary to obtain investment advisory services."

and "treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts." *Id.* at 1280-81. Because "[i]nvestment advice and management fees are commonly incurred outside of trusts," the court reasoned, "these costs are not exempt under section 67(e)(1) and are required to meet the two percent floor of section 67(a)." *Id.* at 1281. The Federal Circuit also found its construction to be consistent with the statute's legislative history. *Id.* It concluded by noting that the trust's reading of the statute, which would find all costs arising out of the trustee's fiduciary duties to fall within the second clause of § 67(e)(1), rendered that clause superfluous "because any costs associated with a trust will always be deductible." *Id.*

The Fourth Circuit subsequently joined the Federal Circuit in holding that investment-advice fees incurred by a trust are subject to the two-percent floor of § 67(a). *Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003). Noting that the "text is clear and unambiguous," the Fourth Circuit stated that "trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers." *Id.* at 139-40. Applying this rule, the court concluded that because investment-advice fees are commonly incurred outside the context of trust administration, they are subject to the two-percent floor. *Id.* The court noted, however, that "[o]ther costs ordinarily incurred by trusts, such as fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns, are not ordinarily incurred by individual taxpayers, and they would be fully deductible under the exception created by § 67(e)." *Id.* These costs, the court explained, are "solely attributable to a trustee's fiduciary duties, and as such are fully deductible under § 67(e)." *Id.* Stating a rationale similar to the Federal Circuit's in Mellon Bank, the court said that to find a trust's investment-advice fees to be fully deductible would lead to

the conclusion that "[a]ll trust-related administrative expenses could be attributed to a trustee's fiduciary duties," rendering the second clause of § 67(e)(1) meaningless. *Id.*

III. *Analysis*

The Trust contends that the Sixth Circuit construed § 67(e)(1) correctly and that the Federal and Fourth Circuits interpreted the provision inconsistently with both its plain language and legislative history. The Trust's principal textual argument is that the second clause of § 67(e)(1) creates a "but for" causation test, excluding from full deduction only those costs which would have been incurred even in the absence of the trust's ownership of the property, i.e., without the trustee. The Trust also relies on the drafting history of § 67(e)(1) to make the somewhat different argument that by enacting that particular section, Congress intended only to prevent trusts from fully deducting those administrative expenses incurred by pass-through entities in which they had invested. For the reasons that follow, we reject both arguments.

A. *Statutory Language*

The Trust reads § 67(e)(1) to reflect Congress's intent to allow a full deduction for the administrative costs of a trust that are attributable to the fiduciary duty of the trustee. The Trust argues that the statute sets forth a "but for" causal test: if the cost would not have been incurred without the trustee, then it is attributable to the trustee's performance of its fiduciary duty and is thus fully deductible under § 67(e)(1). According to the Trust, therefore, the second prong of § 67(e)(1) requires no consideration of whether a generic individual owner of the same assets may have incurred the cost at issue. Rather, the Trust contends that the causation test "plainly" entails "a simple exercise of removing the trustee from the property and seeing which costs remain and which ones disappear without him." The Trust points to specific statutory language in advancing this view. It reads

the statute's use of the language "such trust" to refer to the specific trust under consideration, its trustee and that trustee's duties, rather than to the generic trust of § 67(e)'s introductory language, that is, a trust of the type to which § 67(e) is applicable.[2] Under the Trust's construction, the statute requires consideration of whether a particular cost would have been incurred if the trustee had never existed. It would ignore, however, how an individual property owner managing the same assets would have acted. For the following reasons, we find the Trust's interpretation unreasonable.

As an initial matter, had Congress intended to create a causation test of the type the Trust advances, which disregards what an individual asset owner may have done if the assets were not held in trust, it could have done so in language clearly expressing that intent. Such a "but for" causation test, however, is not apparent from the text's "ordinary, common meaning." *See Luyando v. Grinker*, 8 F.3d 948, 950 (2d Cir. 1993) (noting we interpret a statute according to the "ordinary, common meaning" of the statute's "plain language"). On the contrary, the phrase "if the property were not held in such trust" more logically directs

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[2] The Trust thus contends that the word "such" in the statute, emphasized below, refers to "the" estate or trust mentioned in the first clause of § 67(e)(1), also emphasized below, which it understands to refer not to the generic estate or trust mentioned in the introductory text of § 67(e)(1), but to the particular trust at issue.

> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as is the case of an individual, except that -(1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate. . . .

26 U.S.C. § 67(e)(1) (emphasis added).

the inquiry away from the trust and back toward the hypothetical ownership of the property by an individual. That is, the introductory language of § 67(e) takes as its point of reference the rules that apply to individual taxpayers, and by using the phrase, "if the property were not held in such trust," Congress has aimed the inquiry at the costs that a hypothetical individual property owner could incur with respect to that property. We therefore agree with the Fourth Circuit's statement in *Scott* that the second prong of § 67(e)(1) does not ask whether the costs at issue are commonly incurred in the administration of trusts or are incurred as a result of a particular trustee's fiduciary duty. It focuses the inquiry, instead, on the hypothetical situation where the assets are in the hands of an individual. *See* 328 F.3d at 140.

Although the statutory language directs the inquiry toward the counterfactual condition of assets held individually instead of in trust, the statute does not require a subjective and hypothetical inquiry into whether a particular, individual asset owner *would* have incurred the particular cost at issue. Nothing in the statute indicates that Congress intended the test for the exception to the two-percent floor to give rise to factual disputes about whether an individual asset owner (or owners) is insufficiently financially savvy or the assets sufficiently large such that he or she unquestionably would have sought investment advice. Instead, the plain meaning of § 67(e)(1)'s second clause excludes from full deduction those costs of a type that *could* be incurred if the property were held individually rather than in trust. In other words, for the trust to avoid the two-percent floor and have advantage of the full deduction, the plain language of the statute requires certainty that a particular cost "would not have been incurred" if the property were not held in trust.

For that reason, the statute demands not a subjective and hypothetical inquiry, but rather an objective determination of whether the particular cost is one that is peculiar to trusts and

one that individuals are incapable of incurring. In other words, the statute sets an objective limit on the availability of a full deduction and, as the source of that limit, looks to those costs that individual property holders are capable of incurring and permitted to deduct from adjusted gross income. For example, the fact that investment-advice fees are subject to the two-percent floor under regulations applicable to individual taxpayers proves the fees to be a cost that individual taxpayers are capable of incurring. Investment-advice fees and other costs that individual taxpayers are capable of incurring are, therefore, not fully deductible pursuant to § 67(e)(1) when incurred by a trust. By contrast, costs that individuals are incapable of incurring, like "fees paid to trustees, expenses associated with judicial accountings, and the costs of preparing and filing fiduciary income tax returns," *Scott*, 328 F.3d at 140, are fully deductible.

We thus join the Federal and Fourth Circuits in holding that § 67(e)(1) does not exempt from § 67(a)'s two-percent floor investment-advice fees incurred by trusts. We disagree, however, with their statement that costs "not *customarily* incurred outside of trusts" are the ones not subject to the floor, *Mellon Bank*, 265 F.3d at 1281 (emphasis added); *Scott*, 328 F.3d at 139-40 (citing *Mellon Bank* and stating that § 67(e)(1) subjects "expenses *commonly* incurred by individual taxpayers" to the two-percent floor (emphasis added)), because, as explained above, we believe § 67(e)(1) is more restrictive than that. While the Federal and Fourth Circuits' approach properly focuses the inquiry on the hypothetical situation of costs incurred by individuals as opposed to trusts, that inquiry into whether a given cost is "customarily" or "commonly" incurred by individuals is unnecessary and less consistent with the statutory language. We believe the plain text of § 67(e) requires that we determine with certainty that costs could not have been incurred if the property were held by an individual. We

therefore hold that the plain meaning of the statute permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner.

In so doing, we reject the Trust's argument that, in construing § 67(e)(1) to refer to costs incurred by a generic trust rather than the particular trust under consideration, we must ignore the word "such" in the second clause of § 67(e)(1). The statute's introductory language references a generic "estate or trust" by stating that, "[f]or the purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual," subject to the exception under consideration on this appeal. 26 U.S.C. § 67(e) (emphasis added). The first clause of § 67(e)(1) next uses the different phrase "*the* estate or trust" in setting forth the condition that, to qualify for a full deduction, a cost must be "paid or incurred in connection with the administration of the estate or trust." *Id.* § 67(e)(1) (emphasis added). The second clause of § 67(e)(1) refers to " such estate or trust" in establishing that an administrative cost is fully deductible only if it "would not have been incurred if the property were not held in such trust or estate." *Id.* (emphasis added). For the following reason, we agree with the Commissioner that, as used here, "such trust" is best understood as referring to the generic trust of § 67(e)'s introductory language and not to any actual, particular trust that incurred a cost subject to scrutiny. In the first clause of § 67(e)(1), the language "the estate or trust" plainly refers not to a particular trust under consideration, but to the generic estate or trust mentioned in the provision's introductory language. The phrase "such trust or estate" of § 67(e)(1)'s second clause also refers, therefore, to the generic estate or trust mentioned in both the introductory language of § 67(e) and in the first clause of § 67(e)(1). Moreover, as explained, nothing in the statute indicates that Congress intended to make applicability of the deduction dependent on what costs are peculiarly incurred by a specific trust.

Even if the statute's meaning were not plain and the Trust's alternative interpretation were not unreasonable, canons of statutory interpretation favor the Commissioner's interpretation of the statute. *See Natural Res. Def. Council, Inc. v. Muszynski*, 268 F.3d 91, 98 (2d Cir. 2001) ("If the plain meaning of a statute is susceptible to two or more reasonable meanings, i.e., if it is ambiguous, then a court may resort to the canons of statutory construction."). Specifically, our conclusion accords with the canon of statutory interpretation requiring that when the statute is ambiguous, we resolve interpretive disputes as to the availability of a tax deduction in favor of the government. "It is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' " *Holmes v. United States*, 85 F.3d 956, 961 n. 3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

B. *Legislative History*

The Trust also invokes the statute's legislative history to support a construction that is somewhat different from, and not obviously consistent with, its textual argument.[3] It

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[3] While the Trust's textual argument is essentially that fiduciary administrative costs are exempt from the two-percent floor, its argument based on the drafting history, as explained below, is that the second clause of § 67(e)(1) makes only the indirect administrative costs of a pass-through entity in which a trust has invested subject to the two-percent floor. If the second clause were so limited, one might think that the statute exempts from the two-percent floor more than simply fiduciary administrative costs. On this view, the statute would appear to exempt from the two-percent floor all costs incurred in connection with the administration of a trust except a trust's share of the administrative costs of a pass-through entity owned, at least in part, by the trust.

contends that the drafting history indicates that Congress added the second clause of § 67(e)(1) in order to restrict a trust's use of pass-through entities to avoid the two-percent floor of § 67(a) and not to limit the deductibility of any other administrative costs of a trust. Because we find the statute's text "clear and unambiguous," we need not address the Trust's legislative history arguments. *See Scott*, 328 F.3d at 139. Even if it were not, however, we disagree that this history supports the Trust's proposed interpretation of the statute discussed above or provides any reason to depart from our reading of the statute's meaning.[4]

Pass-through entities, such as partnerships, S corporations, common trust funds, and nonpublic mutual funds, generally do not pay income taxes at the entity level, but instead pass their tax liabilities on to ultimate taxpayers-generally individuals. *See* Temp. Treas. Reg. 1.67-2T (1988). In the Tax Reform Act of 1986, Congress sought to eliminate the ability of wealthy taxpayers to avoid the two-percent floor of § 67(a) by funneling income through pass-through entities. *See Issues Relating to Passthrough Entities: Hearings Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means on H.R. 1658, H.R. 2571, H.R. 3397, H.R. 4448*, 99th Cong. 1 (1986) (stating the Subcommittee's intent to scrutinize the role of pass-through entities in "facilitating and encouraging tax avoidance techniques"). If there were no restrictions on such entities,

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[4] We note that the legislative history upon which the Federal Circuit relied in *Mellon Bank*, 265 F.3d at 1281, chiefly H.R. Rep. No. 99-426 (1985) and S. Rep. No. 99-313 (1986), predates the introduction of § 67(e)(1)'s second clause, and this history relates to a bill that treated all costs incurred in the administration of a trust or an estate as fully deductible. Thus, unlike the Federal Circuit, we do not view this history as persuasive evidence of the meaning of § 67(e)(1).

an individual could deduct the full cost of investment advice, for example, by placing his or her investments in a pass-through entity, deducting the cost of the advice at the entity level and reporting only the net investment income on his or her individual tax return. Congress addressed this problem by enacting § 67(c), which provides, inter alia, that regulations shall be issued "which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred directly by an individual." 26 U.S.C. § 67(c)(1). Congress also provided, however, that this rule, except as provided in regulations, shall not apply to trusts. *Id.* § 67(c)(3)(B).

At the time Congress added § 67(c), the bill provided that all costs incurred in connection with the administration of a trust were exempted from the two-percent floor of § 67(a) and thus permitted trusts to deduct fully all of their administrative costs. Section 67(e)(1)'s second clause was not included in the versions of the bill that emerged initially from the House and Senate, but was added only in the joint conference draft.[5] Accordingly, under the draft language of §

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[5] The House bill included the following language:

> (c) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.-For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income.

H.R. 3838, 99th Cong. § 67(c) (1985). The Senate Committee on Finance did not amend this provision, but expressed the view that "the bill attempts to reduce the benefits arising from the use of trusts ... by revising the rate schedule applicable to trusts." S. Rep. No. 99-313, 99th Cong. 868 (1986). The second clause of § 67(e)(1) appeared for the first time in the final version of the bill that emerged in the Joint Conference (...continued)

67(e) at the time Congress added § 67(c), a trust, unlike an individual, could fully deduct the cost of investment advice and other administrative expenses incurred by pass-through entities in which the trust had invested. To correct this problem, the Trust argues, Congress added the second clause of § 67(e)(1): trusts and estates could fully deduct only those administrative costs that "would not have been incurred if the property were not held in such trust or estate." According to the Trust, this language was intended to create a limited exception within an exception. Although trust income is to be calculated in the same way as individual income, administrative costs incurred by a trust are not subject to the two-percent floor of § 67(a), except for those administrative costs incurred by a pass-through entity in which the trust has invested (which are subject to the floor).[6]

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Agreement. *See* H.R. Rep. No. 99-841, vol. II, at 34 (1986) (Conf. Rep.), *reprinted at* 1986 U.S.C.C.A.N. 4075, 4122.

[6] The Trust relies most heavily in making this argument on the House Conference Report, which provides some indication that the second clause of § 67(e)(1) was drafted to address indirect deductions through pass-through entities. The Trust relies on the following passage from the Report:

> Pursuant to Treasury regulations, the [two-percent] floor is to apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates, nongrantor trusts, cooperatives, and REITs. The floor also applies with respect to indirect deductions through grantor trusts, partnerships, and S corporations by virtue of present-law grantor trust and pass-through rules. *In the case of an estate or trust, the conference agreement provides that the adjusted gross income is to be computed in the same manner as in the case of an individual, except that the deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such trust or estate are treated as allowable in arriving at adjusted gross income and hence are*

(...continued)

If Congress's only purpose had been to restrict the ability of trusts as ultimate taxpayers to deduct fully their share of the administrative costs of pass-through entities in which they had invested, however, it could have drafted the second clause of § 67(e)(1) more narrowly. It could have, for example, permitted full deductibility for those administrative costs "which are not pass-through costs restricted under section 67(c)." Instead, Congress chose the broader language of § 67(e)(1). Thus, notwithstanding the narrow purpose the Trust attributes to Congress in enacting the second clause of § 67(e)(1), the broad statutory language is the best indication that Congress intended to treat those administrative costs that would be subject to the two-percent floor when incurred by an individual as similarly subject to that floor when incurred by a trust. Nothing in the legislative history suggests a clearly expressed congressional intent contrary to the plain meaning of the statute itself.[7] *See Toibb*, 501 U.S. at 162, 111 S.Ct. 2197.

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> *not subject to the floor.* The regulations to be prescribed by the Treasury relating to application of the floor with respect to indirect deductions through certain pass-through entities are to include such reporting requirements as may be necessary to effectuate this provision.

H.R. Rep. No. 99-841, at 34, reprinted at 1986 U.S.C.C.A.N. 4075, 4122 (emphasis added).

[7] The Trust also argues that its reading of the statute in light of the legislative history eliminates the superfluity problem that the Federal and Fourth Circuits, as well as the Commissioner in this case, identified. The Federal and Fourth Circuits both concluded that to interpret § 67(e)(1)'s second clause similarly to the "but for" causation test the Trust advances here renders that clause superfluous because "[a]ll trust-related administrative expenses could be attributed to a trustee's fiduciary duties." *Scott*, 328 F.3d at 140; *Mellon Bank*, 265 F.3d at 1281 ("Under Mellon's construction, the second prerequisite of section 67(e)(1) would (...continued)

## CONCLUSION

Because § 67(e)(1) unambiguously exempts from the two-percent floor of § 67(a) only those costs incurred by a trust that could not have been incurred if the property were held by an individual, we conclude that the Trust's investment-advice fees are deductible only to the extent that they exceed two percent of the Trust's adjusted gross income. This conclusion follows from the fact that individual property owners obviously can incur investment-advice fees and from the regulation explicitly including investment-advice fees among an individual's miscellaneous itemized deductions subject to § 67(a)'s two-percent floor. *See* Temp. Treas. Reg. § 1.67-1T(a)(1)(ii). Accordingly, the investment-advice fees the Trust paid to Warfield do not meet the requirements of § 67(e)(1) and therefore are not fully deductible. For the foregoing reasons, we AFFIRM the judgment of the tax court.

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be rendered superfluous because any costs associated with a trust will always be deductible."). We do not adopt the Federal and Fourth Circuits' view. The Trust contends that the second clause is necessary to filter out a specific subset of the administrative costs described in the first clause-those incurred by pass-through entities in which a trust has invested. Assuming arguendo that such costs are "incurred in connection with the administration" of a trust for purposes of the statute (and satisfy the first clause), they are not caused by the trustee's fiduciary duty (and so fall outside the Trust's reading of the second clause). We find it difficult to conceive that a trustee's fiduciary duty could require that trust assets be invested in a particular vehicle.

# APPENDIX B

124 T.C. No. 19

UNITED STATES TAX COURT

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3297-04. Filed June 27, 2005.

T is a trust established in 1967. The trustee engaged an outside firm to provide investment management advice for T, and the firm was paid $22,241.31 for such services during the 2000 taxable year. On its Federal income tax return, T deducted these fees (rounded) in full.

*Held*: The investment advisory fees paid by T are not fully deductible under the exception provided in sec. 67(e)(1), I.R.C., and are deductible only to the extent that they exceed 2 percent of the T's adjusted gross income pursuant to sec. 67(a), I.R.C.

Michael J. Knight (specially recognized), for petitioner.

*Frank W. Louis*, for respondent.

WHERRY, *Judge*: Respondent determined a Federal income tax deficiency in the amount of $4,448 with respect to the 2000 taxable year of the William L. Rudkin Testamentary Trust (the trust). The sole issue for decision is whether investment advisory fees paid by the trust are fully deductible under the exception provided in section 67(e)(1) or whether the fees are deductible only to the extent that they

exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a).[1]

## FINDINGS OF FACT

The majority of the facts have been stipulated and are so found. The stipulations of the parties, with accompanying exhibits, are incorporated herein by this reference. Michael J. Knight serves as trustee of the trust and provided an address in Fairfield, Connecticut, at the time the petition in this case was filed.

The trust was established under the will of Henry A. Rudkin on April 14, 1967.[2] Henry A. Rudkin's family was involved in the founding of Pepperidge Farm, a food products company. Pepperidge Farm was sold to Campbell Soup Company in the 1960s, and the trust was initially funded primarily with proceeds from that sale.

The will of Henry A. Rudkin referenced above sets forth the governing provisions of the trust. In general, income and principal of the trust were to be applied for the benefit of Henry A. Rudkin's son, William L. Rudkin, and the son's spouse, descendants, and spouses of descendants. Principal distributions were also subject to a special power of appointment held by William L. Rudkin. The trustee and other fiduciaries of Henry A. Rudkin's estate were provided with broad authority in the management of property,

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the year in issue, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2] The will refers to the trust as the "William L. Rudkin Family Testamentary Trust", but all other documents contained in the record omit "Family" from the name. The difference is not material.

including the authority "to invest and reinvest the funds of my estate or of any trust created hereunder in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel".

The trustee engaged Warfield Associates, Inc., to provide investment management advice for the trust. During the taxable year 2000, Warfield Associates, Inc., was paid $22,241.31 for its services.

A Form 1041, U.S. Income Tax Return for Estates and Trusts, for the 2000 year was timely filed on behalf of the trust. Thereon the trust reported total income of $624,816. The Form 1041 also reflected, among other things, a deduction of $22,241 on line 15a for "Other deductions *not* subject to the 2% floor", further described on an attached statement as "INVESTMENT MANAGEMENT FEES". No deduction was claimed on line 15b for "Allowable miscellaneous itemized deductions subject to the 2% floor".

On December 5, 2003, respondent issued to the trust a statutory notice of deficiency determining the aforementioned $4,448 deficiency for the taxable year 2000. Respondent disallowed full deduction of the $22,241 in investment fees and instead permitted a deduction of $9,780, the amount by which $22,241 exceeded 2 percent of adjusted gross income of $623,050 (i.e., $12,461).

The trustee filed the underlying petition in this case disputing respondent's determination on grounds that the

investment advisory fees should not be subject to the 2-percent limitation. During trial preparations, the parties became aware that the notice of deficiency contained an error in its computation of adjusted gross income. The parties have now stipulated that the correct adjusted gross income figure is $613,263, for a corresponding deduction under respondent's position of $9,976. However, on account of the alternative minimum tax, the parties are in further agreement that the resultant deficiency if respondent's position is sustained remains unchanged at $4,448.

## OPINION

### I. *General Rules*

As a general rule, the Internal Revenue Code imposes a Federal tax on the taxable income of every individual and trust. Sec. 1. Taxable income is defined as gross income less allowable deductions. Sec. 63(a). Gross income broadly comprises "all income from whatever source derived," sec. 61(a), and allowable deductions are calculated through application of a multi-tiered process. First, certain enumerated deductions may be subtracted from gross income to arrive at adjusted gross income. Sec. 62(a). Itemized deductions may then be subtracted from adjusted gross income in arriving at taxable income. Sec. 63(d).

Itemized deductions, however, are further segregated into two categories that impact on their deductibility. Section 67(b) sets forth a list of itemized deductions allowed without further limitation to the extent permitted under the appropriate statutory section authorizing the deduction. For individual taxpayers, the remaining itemized deductions are characterized as "miscellaneous itemized deductions" and are allowed under section 67(a) only to the extent that they exceed 2 percent of adjusted gross income. For estates and

trusts, section 67(e) mandates application of the rule of section 67(a), with specified modifications. Specifically, section 67 provides as follows in relevant part:

> SEC. 67. 2-PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS.
>
> (a) General Rule.-In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.
>
> * * * * * * * * *
>
> (e) Determination of Adjusted Gross Income in Case of Estates and Trusts.-For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that-
>
> (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate * * *
>
> * * * * * * * *
>
> shall be treated as allowable in arriving at adjusted gross income. * * *

Hence, the statutory text of section 67(e)(1) creates an exception allowing for deduction of trust expenditures without regard to the 2-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection

with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

In that vein, regulations promulgated under section 67 list examples of expenses that, in the context of individuals, are subject to the 2-percent floor. Sec. 1.67-1T(a)(1), Temporary Income Tax Regs., 53 Fed. Reg. 9875 (Mar. 28, 1988).[3] Included are expenses incurred "for the production or collection of income for which a deduction is otherwise allowable under section 212(1) and (2), such as *investment advisory fees*, subscriptions to investment advisory publications, certain attorneys' fees, and the cost of safe deposit boxes". Sec. 1.67-1T(a)(1)(ii), Temporary Income Tax Regs., *supra* (emphasis added).

II. *Contentions of the Parties*

Against this backdrop, the trustee contends that the investment management fees in dispute here are properly deductible under the exception set forth in section 67(e)(1). The trustee maintains that the fees were paid in connection with administration of the trust and would not have been incurred if the property were not held in trust. In reaching this conclusion, the trustee relies largely on the fiduciary duties imposed on trustees. According to the trustee, while an individual may make a voluntary and personal choice to seek investment advice, fiduciary duties render such professional advice a necessary and "involuntary" component of trust administration.

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[3] Temporary regulations are entitled to the same weight and binding effect as final regulations. *Peterson Marital Trust v. Commissioner*, 102 T.C. 790, 797 (1994), affd. 78 F.3d 795 (2d Cir. 1996).

In contrast, it is respondent's position that the section 67(e)(1) exception does not apply to the expenses at issue. Respondent does not dispute the expenditures were made in connection with the administration of the trust. However, respondent alleges that because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the fees fail to satisfy the requirement that they would not have been incurred if the assets were not held in trust. It is also respondent's view that neither State law nor the governing trust instrument imposed a legal obligation on the fiduciary to obtain professional investment management services.

III. *Analysis*

The deductibility of investment advisory fees by a trust under section 67(e)(1) is not a matter of first impression. This Court and three Courts of Appeals have ruled on the question. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001); *O'Neill v. Commissioner*, 994 F.2d 302 (6th Cir. 1993), revg. 98 T.C. 227 (1992). The result has been a split in authority on the issue.

This Court in *O'Neill v. Commissioner*, 98 T.C. at 230-231, held that investment advice costs were not deductible under section 67(e), reasoning as follows:

> We believe that the thrust of the language of section 67(e) is that only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth at section 67(a). Examples of items unique to the administration of a trust or estate would be the

> fees paid to a trustee and trust accounting fees mandated by law or the trust agreement. Individual investors routinely incur costs for investment advice as an integral part of their investment activities. Consequently, it cannot be argued that such costs are somehow unique to the administration of an estate or trust simply because a fiduciary might feel compelled to incur such expenses in order to meet the prudent person standards imposed by State law.

The Court of Appeals for the Sixth Circuit reversed in *O'Neill v. Commissioner*, 994 F.2d at 304-305. Although the Court of Appeals concurred that "certain expenditures unique to trust administration are excepted from the two percent floor", the Court disagreed with our analysis as to why the costs in dispute were not unique. *Id.* at 303-304. Noting our statement that individual investors routinely incur costs for investment advice, the Court of Appeals opined: "Nevertheless, they are not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust." *Id.* at 304.

Subsequently, the Courts of Appeals for the Federal and Fourth Circuits in *Mellon Bank, N.A. v. United States*, supra, and *Scott v. United States*, *supra*, respectively, diverged from the position taken by the Court of Appeals for the Sixth Circuit. These latter rulings were consistent in their rationale and result, summarized as follows by the Court of Appeals for the Fourth Circuit:

> the second requirement of § 67(e)(1) does not ask whether costs are commonly incurred in the administration of trusts. Instead, it asks whether

> costs are commonly incurred *outside* the administration of trusts. As the Federal Circuit decided in *Mellon Bank*, investment-advice fees are commonly incurred outside the administration of trusts, and they are therefore subject to the 2% floor established by § 67(a). * * * [*Scott v. United States*, *supra* at 140.]

See also *Mellon Bank, N.A. v. United States*, *supra* at 1281 ("the second requirement treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts").

In construing section 67(e)(1), the Courts of Appeals for both the Federal and Fourth Circuits emphasized the importance of not interpreting the statute so as to render superfluous any portion thereof. *Scott v. United States*, *supra* at 140; *Mellon Bank, N.A. v. United States*, *supra* at 1280. Moreover, both courts explicitly rejected the taxpayers' arguments premised on fiduciary duties as running afoul of this principle of construction. *Scott v. United States*, *supra* at 140; *Mellon Bank, N.A. v. United States*, *supra* at 1280-1281. In the words of the Court of Appeals for the Fourth Circuit:

> we would, by holding that a trust's investment-advice fees were fully deductible, render meaningless the second requirement of § 67(e)(1). All trust-related administrative expenses could be attributed to a trustee's fiduciary duties, and the broad reading of § 67(e)(1) urged by the taxpayers would treat as fully deductible any costs associated with a trust. But the second clause of § 67(e)(1) specifically limits the applicability of § 67(e) to certain types of trust-related administrative expenses. To give effect to this limitation, we must

> hold that the investment-advice fees incurred by the Trust do not qualify for the exception created by § 67(e). Rather, they are subject to the 2% floor established by § 67(a). [*Scott v. United States*, *supra* at 140.]

The Court of Appeals for the Fourth Circuit characterized the contrary analysis in this regard of the Court of Appeals for the Sixth Circuit in *O'Neill v. Commissioner*, 994 F.2d at 304, as containing "a fatal flaw". *Scott v. United States*, *supra* at 140. The Court of Appeals for the Federal Circuit similarly branded the taxpayer's attempts to bolster its interpretation through legislative history as "unpersuasive." *Mellon Bank, N.A. v. United States*, *supra* at 1281. To wit, the Court of Appeals for the Federal Circuit, tracing the genesis of section 67(e), noted that to premise full deduction of all trust expenses on fiduciary duties would run counter to

> legislative intent to equate the taxation of trusts with the taxation of individuals, limit the ability of sophisticated taxpayers to use trusts or other complex arrangements to lower their tax burden compared to similarly situated individuals, and to minimize the impact of the tax code on economic decision making. [*Id.*]

Having reviewed our initial construction of section 67(e) and the ensuing judicial developments detailed above, this Court concludes that the interpretation set forth in *O'Neill v. Commissioner*, 98 T.C. at 230-231, and expressed by the Courts of Appeals in *Scott v. United States*, 328 F.3d at 139-140, and *Mellon Bank, N.A. v. United States*, 265 F.3d at 1280-1281, remains sound. The trustee here, in support of full deductibility, relies on concepts rejected in the foregoing decisions. Appeal in the instant case, barring stipulation to the contrary, would be to the Court of Appeals for the Second

Circuit, which has not ruled on the issue. See *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir.1971). The Court therefore holds that the investment advisory fees paid by the trust are not fully deductible under the exception provided in section 67(e)(1) and are deductible only to the extent that they exceed 2 percent of the trust's adjusted gross income pursuant to section 67(a).

To reflect the foregoing,

*Decision will be entered for respondent.*

Reviewed by the Court.

GERBER, COHEN, SWIFT, WELLS, COLVIN, HALPERN, CHIECHI, LARO, FOLEY, VASQUEZ, GALE, THORNTON, MARVEL, HAINES, GOEKE, KROUPA, and HOLMES, JJ., agree with this opinion.

## APPENDIX C

# UNITED STATES COURT OF APPEALS
## FOR THE SECOND CIRCUIT
## THURGOOD MARSHALL U.S. COURTHOUSE
## 40 FOLEY SQUARE
## NEW YORK 10007

Thomas Asreen
ACTING CLERK

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
FILED
Date: JAN 19 2007

| | |
|---|---|
| Docket | 05-5151-ag |
| Short Title: | William L. Rudkin Testamentary Trust v. Commission |
| Agency Number: | 3279-04 |
| Agency: | Tax Court, Internal Revenue Service |

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 19 day of January two thousand seven.

William L. Rudkin Testamentary Trust v. Commissioner of Internal Revenue

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant William L. Rudkin Testamentary Trust. Upon consideration by the

panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED**.

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court,
Thomas Asreen, Acting Clerk

By: /s/_____
Motion Staff Attorney

## APPENDIX D

I, HENRY A. RUDKIN, of the Town of Fairfield, County of Fairfield, State of Connecticut, hereby make, publish and declare this my LAST WILL AND TESTAMENT, hereby revoking any and all Wills and Codicils heretofore made by me.

ARTICLE FIRST. If my wife, MARGARET RUDKIN, survives me by six months, I give to her my interest in any real estate which she and I own as tenants in common in the States of Connecticut and Florida.

ARTICLE SECOND.

(1) If my wife, MARGARET RUDKIN, survives me by six months, I give to her all of my tangible personal property. If she does not survive me by six months, I give all of such property in equal shares per stirpes to descendants living at my death. I request (but I do not direct) the donee or donees of such property to dispose of certain articles thereof in accordance with a memorandum or list which I expect to attach to this will, or if I should fail to attach such a memorandum or list, in accordance with his or their knowledge of my wishes as I have expressed them or may hereafter express them from time to time.

(2) If my wife, MARGARET RUDKIN, survives me by six months, I give to her that fraction of my residuary estate (before the payment of the estate, inheritance, succession and similar taxes thereon), which equals the maximum marital deduction allowable in the final determination of the Federal Estate Tax upon my estate, reduced by the value as finally determined for Federal Estate Tax purposes of all other items of my gross estate

Identifying Initials /s/ HAR

qualifying for said marital deduction which pass or have passed to my wife under other provisions of this Will or by operation of law or otherwise. The final determination in the Federal Estate Tax proceedings shall control the computation of such fractional share. When distribution of my residuary estate is made, the fractional share thereof as computed above shall be distributed to my wife regardless of whether the then value of my residuary estate is more or less than the value thereof used in the final determination of the Federal Estate Tax.

ARTICLE THIRD. At any time within ninety days following the filing with the probate court having jurisdiction of my estate of an inventory and appraisal thereof, I authorize my wife, MARGARET RUDKIN, to disclaim, either in whole or in part, any gifts, interests of benefits which would otherwise pass to her under ARTICLES FIRST or SECOND hereof, by written instrument or instruments filed with the Executors hereinafter named.

* * *

ARTICLE FIFTH. I give forty-five per cent of all the rest of my property and estate, of whatsoever the same may consist and wheresoever the same may be located, (or the remaining fifty per cent thereof if my son, JOHN MARK RUDKIN, does not survive me), to the trustees hereinafter named (hereinafter called the "Trustees") IN TRUST (as the "William L. Rudkin Testamentary Family Trust") for the following purposes and upon the following terms:

Identifying Initials /s/ HAR

(1) Until twenty-one years after the death of the last survivor among my descendants living at my death (or until the earlier deaths of my son, WILLIAM L. RUDKIN, and all of his descendants), the Trustees shall pay to or apply the for the benefit of all or any of the members from time to time of the class comprising my son, WILLIAM L. RUDKIN, his wife or widow, and the descendants and spouses of descendants of my said son, so much of the net income of the trust as the Trustees deem necessary or desirable in their discretion for the support, comfort and education of such members, or any one or more of them, with no requirement of equality of treatment among them, it being my intention and desire that the Trustees shall make such payment in accordance with their understanding of the individual and varying needs and resources from time to time of the members of such class; and the Trustees shall annually pay any income not so distributed in accordance with the foregoing provisions to the Trustee hereunder, to be held IN TRUST for such members, or any one or more of them, in trusts separate and apart from the trust created hereby, without any requirement of equality of treatment among such trusts; and each such trust so maintained for any such member shall be held and administered in accordance with the terms and for the purposes set forth in ARTICLE SEVENTH hereof, dealing with beneficiaries' accumulation trusts.

(2) During the existence of the trust, the Trustees may in their discretion at any time or from time to time distribute all or any part of the principal of the trust to any one or more of the members of the class described in subsection (1) of this ARTICLE FIFTH, with no requirement of equality in making such distribution.

Identifying Initials /s/ HAR

(3) During the existence of the trust, the Trustees shall distribute such portions of the principal of the trust to such persons and organizations (excluding my son, WILLIAM L. RUDKIN, his estate, his creditors and the creditors of his estate), and in such shares, in trust or otherwise, as my son, WILLIAM L. RUKIN, shall direct by written instrument or instruments delivered to the Trustees during his life or by specific reference to this special power of appointment in his Will duly admitted to probate.

(4) Twenty-one years after the death of the last survivor among my descendants living at my death (or on the earlier deaths of my son, WILLIAM L. RUDKIN, and all of his descendants), the Trustees shall transfer and deliver the principal of the trust as then constituted in equal shares per stirpes to the descendants then living of my son, WILLIAM L. RUDKIN (or in equal shares per capita if all such descendants are members of the same generation); or, if there be no such descendant, in equal shares per stirpes to my descendants then living (or in equal shares per capita if all such descendants are members of the same generation).

* * *

ARTICLE TENTH. I authorize my Executors and Trustees, in their respective capacities and discretions, as follows:

(1) to settle on such terms as they may deem advisable any claims of my estate or of any trust created hereunder against others or of others against my estate or against such trust;

(2) to complete any contracts and to pay or extend or renew any loans or debts which I may have or which may be owing to me at my death;

(3) to borrow from time to time such sums as they may deem advisable to facilitate the exercise of any rights, options, or privileges of the character referred to in subdivision (10) of this ARTICLE TENTH or for such other purposes as them may deem advisable for the preservation or benefit of my estate or of any trust created hereunder, and to secure any sum so borrowed by the pledge or mortgage of any securities or other properties constituting a part of my estate or of such trust;

(4) to sell, lease, mortgage, pledge, transfer, exchange or otherwise dispose of any securities or other properties which I may own at my death or which may come into their possession or under their control at any time hereunder upon such terms as to the payment or otherwise (including with respect to any lease, the term thereof) as they may deem advisable, and to execute and deliver such deeds, leases, assignments or other written instruments, with or without covenants, as may be necessary

Identifying Initials /s/ HAR

or convenient to accomplish such purposes (and no purchaser, lessee, mortgagee, pledgee, transferee or exchangee shall be required to see to the application of the proceeds thereof or to inquire into the validity, expediency or propriety thereof);

(5) to determine the date for the valuation of property in my gross estate for purposes of the Federal Estate Tax;

(6) to claim any expenses of administration of my estate as income tax deductions upon an income tax return or returns whenever in the judgment of my executors such action will achieve an over-all reduction in income and death taxes, and without making any adjustment therefor of income and principal accounts in my estate;

(7) to invest and reinvest the funds of my estate or of any trust created hereunder in such manner as they deem advisable without being restricted to the investments of the character authorized by law for the investment of estate or trust funds; including the investment in non-income producing securities and securities issued by the United States, any State, any municipality and any political subdivision of the United States, any State or any municipality and the holding of funds uninvested such as they may deem advisable;

(8) to purchase investment securities at a premium or discount and without any obligation to amortize such premium or discount;

(9) to cause any investment securities or other properties held by them hereunder to be registered or held in the name or names of a nominee or nominees without being required to

describe the capacity in which or the authority under which such securities or other properties are held, or to hold any such securities or other properties unregistered and in bearer form, without in any such case thereby changing their liability hereunder;

(10) to vote in person or by proxy any securities or other properties held by them hereunder with respect to which voting rights may at any time be exercised by the holders thereof; to exercise any rights, options or exchange or conversion privileges at any time pertaining to any securities or other properties held by them hereunder; and, generally, to exercise in respect of any securities or other properties held by them hereunder all such rights, powers and privileges as could be exercised lawfully by any natural person owning similar securities or other properties in his own right;

(11) to continue in force any policies of insurance on the life of my wife, MARGARET RUDKIN, which I may own at my death and, without limiting the generality of the foregoing or of the investment authority conferred by subsection (7) of this ARTICLE TENTH, to purchase insurance on the life of the beneficiary of any trust created hereunder or on the life of any person in whom such beneficiary has an insurable interest, naming as the beneficiary of any such policy either the trust itself or the beneficiary on whom or with respect to whom the policy was taken out; to pay premiums, assessments, and proper charges on any such policy either out of income or principal; and to exercise all or any rights granted under any such policy as they in their discretion deem necessary or desirable;

Identifying Initials /s/ HAR

(12) to make all payments, division and distributions hereunder either in money or in property or partly in money and partly in property as they may deem advisable, their judgment as to the fairness and equality of such payment, division or distribution to be final and binding upon all persons interested hereunder as to both the kind and value of any property designated by them for such disposition;

(13) to pay or deliver all or any part of the money or other property to which any minor or incompetent person shall be entitled to hereunder to the parent or to the legal guardian of the person of such minor or to any person with whom such minor is residing or to the legal representative of such incompetent person and to accept the receipt of such parent or guardian or person or legal representative for the money other property so paid over or delivered as a full release from further responsibility therefor;

(14) to pay to the beneficiary entitled to the next succeeding estate any dividends declared but not paid and any interest or other income accrued but not received on or before the date of the termination of the preceding estate;

(15) to determine what expenses, costs, taxes and other charges of all kinds (including executors' and Trustees' fees) shall be charged against income and what against principal or to apportion the same between income and principal in such amounts as they may deem proper, their decision with respect thereto to be final and binding upon all persons interested hereunder;

(16) to apportion appreciation or capital gain realized on the sale of any non-income producing security or other non-

income producing property held by them hereunder between income and principal in such amounts as they may deem proper, their decision with respect thereto to be final and binding upon all persons interested hereunder;

(17) to rely upon any affidavit, certificate, letter, notice, telegram or other paper or upon any telephone conversation believed by them to be genuine and upon any other evidence believed by them to be sufficient, and to be protected and saved harmless in all payments or distributions required to be made hereunder if made in good faith and without actual notice or knowledge of the changed condition or status of any person receiving payments or other distributions upon a condition;

(18) to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of my estate and of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel; and

(19) to deal generally with my estate and with any trust created hereunder as in their judgment the best business interests thereof may require.

* * *

IN WITNESS WHEREOF, I have hereunto set my hand and seal to this Will (consisting of this page and the twenty-five preceding typewritten pages, each of which is identified by my initials at the bottom thereof) at Fairfield, Connecticut, this day of October, One Thousand Nine Hundred and Sixty-Five.

/s/ Henry A. Rudkin (L.S.) [seal]

Signed, sealed and declared to be his LAST WILL AND TESTAMENT by the above-named Testator, HENRY A. RUDKIN, in the presence of us, who, in his presence and at his request and in the presence of each other, have hereunto subscribed our names as witnesses

| | |
|---|---|
| /s/ Robert J. Berta | Shelton, Connecticut |
| /s/ Marie N. Pennell | Fairfield, Conn. |
| /s/ David O. Pendleton | Westport, Conn. |

STATE OF CONNECTICUT)
:ss.Fairfield, October 11, 1965
COUNTY OF FAIRFIELD )

The within-named ROBERT J. BERTA, MARIE N. PENNELL, and DAVID O. PENDLETON, being duly sworn, depose and say that they witnessed the within WILL of the within-named Testator, HENRY A. RUDKIN, and subscribed the same in his presence and at his request, and in the presence of each other; that the said HENRY A. RUDKIN, at the time of the execution of said WILL, appeared to them to be of full age and of sound mind and memory; and that he signed said WILL and declared the same to be his LAST WILL AND TESTAMENT in their presence, and that they make this affidavit at the request of said Testator.

/s/ Robert J. Berta
/s/ Marie N. Pennell
/s/ David O. Pendleton

Subscribed and sworn to at the request of the within-named Testator, HENRY A. RUDKIN, the day and year above written, before me,

/s/ _____

Notary Public

# CODICIL

to

LAST WILL AND TESTAMENT

of

HENRY A. RUDKIN

DATED:

MARSH, DAY & CALHOUN
BRIDGEPORT

I, HENRY A. RUDKIN of the Town of Fairfield, County of Fairfield and State of Connecticut, hereby make, publish and declare the following to be the First Codicil to my LAST WILL AND TESTMAMENT dated October 11, 1965 hereby confirming said LAST WILL AND TESTAMENT in all particulars except as herein expressly modified:

* * *

THIRD: I hereby amend and change subsection (2) of ARTICLE FIFTH of my said LAST WILL AND TESTAMENT to read as follows:

> "(2) During the existence of the trust, the Trustees may in their discretion at any time or from time to time distribute to any one or more members of the class described in subsection (1) of this ARTICLE FIFTH so much of the principal of such trust as the Trustees may deem necessary or desirable in their discretion for the education, support, comfort and welfare of such members, or any one or more of them, and may also in their discretion make such payments of principal to any one or more of such member of such class as they shall deem necessary or desirable

/s/ HAR

to advance the best interests of such member or members in any business venture in which such member or members may be engaged or in which such member or members may wish to engage. In making all such distributions, there shall be no requirement of equality as among various members of the class, and the Trustees shall not be bound to take into account the other sources of income or the capital resources of such members."

* * *

IN WITNESS WHEREOF, I have hereunto set my hand and seal at Fairfield, Connecticut, this 1st day of December One Thousand Nine Hundred and Sixty-five.

/s/ Henry A. Rudkin (L.S.) [seal]

Signed, sealed and declared to be a CODICIL to his LAST WILL AND TESTAMENT by the above-named Testator, HENRY A. RUDKIN, in the presence of us, who in his presence and at his request, and in the presence of each other, have hereunto subscribed our names as witnesses.

| | |
|---|---|
| /s/ Robert J. Berta | Shelton, Conn. |
| /s/ Marion Ryan | Norwalk, Conn. |
| /s/ Marie N. Pennell | Fairfield, Conn. |

STATE OF CONNECTICUT)
:ss.Fairfield, December 1, 1965
COUNTY OF FAIRFIELD )

The within-named Robert J. Berta, Marion Ryan and Marie N. Pennell, being duly sworn, depose and say that they

witnessed the within CODICIL to the LAST WILL AND TESTAMENT of the within-named Testator, HENRY A. RUDKIN, and subscribed the same in his presence and at his request, and in the presence of each other; that the said HENRY A. RUDKIN, at the time of the execution of said CODICIL, appeared to them to be of full age and of sound mind and memory, and that he signed said CODICIL and declared the same to be a CODICIL to his LAST WILL AND TESTAMENT in their presence, and that they make this affidavit at the request of said Testator.

/s/ Robert J. Berta

/s/ Marion Ryan

/s/ Marie N. Pennell

Subscribed and sworn to at the request of the within-named Testator, HENRY A. RUDKIN, the day and year above written, before me,

/s/_____

Notary Public

## APPENDIX E

**JPMorgan**
**Private Bank**

**A. Dean Theiss, Jr., CTFA**
Vice President & Manager
Fiduciary Specialized Services

February 21, 2007

Dear Tax Preparer:

Please find enclosed the tax worksheet(s) and other relevant information for the trust(s) for which you have been engaged to prepare the income tax return(s). We would like to make you aware of recent court cases that may have an impact on the tax treatment of the deductibility of investment fees or asset custody fees paid.

A number of years ago the Federal income tax law was changed for both individual and trust taxpayers. The law currently states that for the purpose of computing the regular income tax, certain miscellaneous expenses must be reduced by 2% of the adjusted gross income before deducting them on a tax return. It also states that, for the purpose of computing the alternative minimum tax, miscellaneous itemized deductions are completely disallowed. The 2% rule does not apply to trust administrative expenses that would not have been incurred had the property not been placed in trust. For example, trustee commissions are generally not considered to be miscellaneous itemized deductions since they are administrative expenses unique to trust accounts. Alternatively, investment management fees and asset custody fees are considered miscellaneous itemized deductions that would be subject to the 2% rule.

The application and interpretation of the tax law to trust accounts has not been consistent in the court systems. Previously we had been relying on a favorable decision in the Sixth Circuit (O'Neill case) where the investment management fees were not subjected to the 2% limitation.

There have been several recent court cases whereby the Internal Revenue Service took the position that investment management fees paid from a trust are deductible only to the extent they exceed 2% of the adjusted gross income of the trust. The Tax and Appellate Courts in the Second Circuit (Rudkin), the Fourth Circuit (Scott), and in the Federal Circuit (Mellon), each ruled in favor of the IRS. Generally, we have been advised that the tax filings for trust accounts subject to these Circuit Courts should be prepared consistent with the rulings. It is our understanding that the residence of the trustee determines which Circuit Court has jurisdiction.

For the purpose of determining residence, the principal place of business for JP Morgan Chase Bank, N.A. is located in New York, which is in the Second Circuit. Therefore, if JPMorgan Chase Bank, N.A. is the sole trustee, we ask that beginning in 2006 you follow the IRS position of applying the 2% limitation if there are any applicable expenses. This would also apply if all co-trustees are domiciled in the Second, Fourth, or Federal Circuits.

However, if there are any co-trustees that reside outside the Second, Fourth, or Federal Circuits, we ask that for 2006 you do not apply the 2% limitation if there are any applicable expenses.

For your records, the affected Circuit Courts include the following states –
Second – New York, Connecticut, and Vermont

Fourth – Maryland, North Carolina, South Carolina, Virginia, and West Virginia
Federal – District of Columbia and Foreign

We will continue to monitor legislative and judicial decisions with regard to the IRS' position on the deductibility of these and other expenses, and will let you know of any significant changes that will impact the preparation of our tax returns.

Also enclosed is a spreadsheet containing a list of the accounts for which you will be preparing the income tax return. Please note that in the column labeled **"Subject to 2% AGI Reduction 3rd Party Investment Fee"**, we have indicated with a "Yes" those accounts we have determined to be subject to the 2% limitation.

If you have any questions or need additional information, feel free to contact me.

Sincerely,

/s/_____
A. Dean Theiss, Jr.

Enclosures

**IRS Circular 230 Disclosure:**
*JPMorgan Chase Co. and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including attachments) is not intended or written to be used, and cannot be used,, in connection with the promotion, marketing, or recommendation by anyone unaffiliated with JP Morgan Chase Co. of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties.*

"JPMorgan Private Bank" is the marketing name for the private banking and brokerage activities conducted by J.P. Morgan Chase & Co. and its subsidiary banks and broker/dealers.